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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

LEASEWAY TRANSPORTATION CORP. and
RAYMOND J. REHOR,

Petitioners,

v.

UNITED STATES OF AMERICA and
JAMES SIMEO,

Respondents.

PETITION OF THE LEASEWAY TRANSPORTATION CORP. and RAYMOND J. REHOR FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D.C.

QUESTION PRESENTED FOR REVIEW

When compelling reasons of public policy protect the confidentiality of Internal Audit Reports prepared by employees of a business for purposes of internal policing, should such Reports routinely and automatically be disclosed to the government by administrative summons without consideration of such reasons?

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PETITION OF THE LEASEWAY TRANSPORTATION CORP. and RAYMOND J. REHOR FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioners the Leaseway Transportation Corp. and Raymond J. Rehor[1/] respectfully

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1/ The caption denotes the parties who appeared below. The Leaseway Transportation Corp. has the following subsidiaries (which are not wholly owned) and affiliates: Signal Delivery Service, Inc. and Leaseway All-Services, Inc. Pursuant to Rules 15.1(b) and 28.1 of the rules of this Court, these representations are made in order that the Judges of this Court may evaluate possible disqualification or refusal.

pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in this proceeding on April 19, 1983.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit (not reported) and the opinion of the United States District Court for the Northern District of Ohio, Eastern Division, reported at 523 F. Supp. 1333, appear in the appendix hereto.

JURISDICTION

The judgment of the United States Court of Appeals for the Sixth Circuit was entered on April 19, 1983. The Petition for Rehearing and Rehearing En Banc, timely filed, was denied on June 7, 1983. This petition for certiorari is filed within 90 days of that date. The jurisdiction of this court is based upon 28 U.S.C. § 2101(c).

STATUTORY PROVISIONS INVOLVED

This case arises under 26 U.S.C. § 7602 (1976), which provides in pertinent part:

> § 7602. Examination of books and witnesses
>
> For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized--
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and
>
> (3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

STATEMENT OF THE CASE

Petitioner Leaseway Transportation Corp. ("Leaseway") is a Delaware corporation engaged in a nationwide business of supplying transportation services to numerous corporations and other customers. These services include the leasing of transportation equipment, the transportation of goods, various warehousing activities and other specialized transportation services. R. at 75.[2/] Petitioner Raymond J. Rehor is Vice-President, Taxes of Leaseway. R. at 72.

The Internal Revenue Service ("IRS") conducted a routine audit of Leaseway's Federal income tax returns for the years 1975 through 1978. In the course of the audit Leaseway fully cooperated with the IRS providing some 1,300 documents to facilitate the audit. R. at 104-105.

2/ The following abbreviations are used:
(continued)

At the conclusion of the audit and with only two minor issues unresolved,[3/] the IRS issued a summons requesting production of Leaseway's Internal Audit Reports ("IARs"), related workpapers and correspondence for the relevant years. R. at 266-270. The summons was issued pursuant to 26 U.S.C. § 7602. The summons would reach 82 of Leaseway's IARs together with related workpapers and correspondence. The decision to issue the summons was made by IRS Audit Case Manager James Simeo without any inquiry or knowledge of what was contained in Leaseway's IARs. R. at 45-46.

2/ (continued)
"R." refers to the record in the district court proceedings. United States v. Leaseway Transportation Corp., 523 F. Supp. 1333 (N.D. Ohio 1981).

"App." refers to the appendix to this brief.

3/ The unresolved issues concerned an engineer's determination of salvage value, which was subsequently resolved and a "competent authority issue" relating to a Canadian operation. R. at 52, 101.

An IAR is a document prepared by select employees of a business for purposes of self-policing.[4/] See R. at 144, 148-149. Leaseway voluntarily prepares IARs to ensure compliance with company policy as well as statutory and regulatory requirements. Id.

When Leaseway refused to produce the requested documents, the United States, on behalf of the IRS, filed a petition in the United States District Court for the Northern District of Ohio, Eastern Division, to enforce the summons pursuant to 26 U.S.C. § 7604. R. at 263-265. On October 15, 1981,

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4/ See V. Brink, J. Cashin & H. Witt, Modern Internal Auditing 629 (1973) (IARs focus on "policies, operational approaches, utilization of resources, manpower performance, and results achieved"); P. Macchiaverna, Internal Auditing: A Research Report from the Conference Board, Inc. 1 (1978) (IARs "evaluate controls, check compliance with policies and procedures, and test reporting systems in the nonfinancial areas of corporate operations as well as in the financial"); H. Stettler, Auditing Principles 88-94 (1977).

the District Court granted the IRS's petition for enforcement of the IRS summons. United States v. Leaseway Transportation Corp., 523 F. Supp. 1333 (N.D. Ohio 1981) (reprinted in the Appendix hereto at App. B-1 - B-21).

Leaseway appealed the judgment of the District Court to the United States Court of Appeals for the Sixth Circuit. On April 19, 1983, the Court of Appeals issued a memorandum opinion and order which affirmed the judgment of the District Court. Leaseway Transportation Corp. v. United States, No. 81-3726 (6th Cir. Apr. 19, 1983) (reprinted in the Appendix hereto at App. A-1 - A-11). Leaseway timely filed a Petition for Rehearing and Rehearing En Banc, which was denied by the Court of Appeals on June 7, 1983. App. at C-1. Petitioners now seek a writ of certiorari to obtain review of the decision of the Court of Appeals.

The Court of Appeals, on motion by petitioners, entered an Order Staying Mandate on

June 16, 1983. The order stayed the mandate of the Court of Appeals for only 30 days from that date; but the court denied petitioners' later motion to extend the stay beyond the present due date for this petition.

REASONS FOR GRANTING THE PETITION

I. Compelling Reasons Of Public Policy Require That Some Protection Be Accorded To Disclosure Of Internal Audit Reports.

A. Use Of The Internal Audit Report Procedure Produces Substantial Public Benefits.

The use of IAR procedure produces substantial public benefits in two significant respects.

1. Their use fosters compliance with the law. IARs are prepared by select employees of a business for purposes of checking and ultimately assuring compliance with the law. See P. Macchiaverna, supra note 4, at 1-4; Institute of Internal Auditors, Inc., Standards for the Professional Practice of Internal Auditing, Inc. 300-1 (1978). Their

use promotes voluntary compliance by businesses with such legislation as the Occupational Safety and Health Act, the Clean Air Act, the Clean Water Act, the Foreign Corrupt Practices Act, the Securities Exchange Act of 1934, and other Federal laws and regulations. See Institute of Internal Auditors, Inc., Survey of Internal Auditing, 1979, at 2 (1980),[5/] hereinafter referred to as the "Survey of Internal Auditing," reproduced and attached hereto at App. D-1 - D-2.

Substantial public benefits follow from corporate voluntary self-policing to ensure compliance with the law. Self-policing ensures compliance with the law in areas of large public concern which may otherwise

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5/ The Survey of Internal Auditing, 1979, is the most comprehensive and recent survey of the use of IARs by businesses. The survey was prepared by the Institute of Internal Auditors from responses to eleven hundred questionnaires sent to a wide variety of corporations.

escape enforcement by the government. See Murphy, The Self-Evaluative Privilege, 7 Journal of Corporation Law 489, 495-496 (1982); cf. Upjohn Co. v. United States, 449 U.S. 383, 392 (1981) (there are social benefits in voluntary corporate compliance with the law). Moreover, government attention and resources need not be devoted to enforcement where there is substantial voluntary compliance with the law by business. Id.; Block & Barton, Internal Corporate Investigations: Maintaining the Confidentiality of A Corporate Client's Communications with Investigative Counsel, 35 Business Lawyer 5, 8 (1979).

2. The use of IARs also produces substantial public benefits through enhancement of corporate efficiency. See United States v. Noall, 587 F.2d 123, 125 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979); R. at 144,

148-49; V. Brink, J. Cashin & H. Witt, supra note 4, at 624-625, 629, 637-639, 741-742. They are used to evaluate "how efficiently and economically management utilizes its resources and how effectively it achieves its objectives." P. Macchiaverna, supra note 4, at 1. In locating operational inefficiencies, IARs cover all areas of corporate activity. See Survey of Internal Auditing at 2; App. at D-1 - D-2.[6/] The potential benefits so derived include lower prices, more productive businesses, greater returns to shareholders and investors and more jobs. See, e.g., P. Macchiaverna, supra note 4, at 8.

6/ The Survey of Internal Auditing identifies 32 major areas of business activity that are reviewed by IARs. See App. at D-2.

B. If The Confidentiality Of Internal Audit Reports Is Not Protected, The Public Benefits Will Be Lost.

The effectiveness of IARs for the above purposes depends upon maintaining their confidential nature both in their preparation and use. Candid evaluation in an IAR of corporate compliance with law or operational efficiency is crucial to the IAR's purpose.7/ See Block & Barton supra p. 10, at 8-17. As this Court stated in Upjohn, "the depth and quality of any [internal corporate] investigations, to ensure compliance with the law would suffer" if such investigations were not confidential. 449 U.S. at 393 n. 2. Absent such confidentiality, businesses would no longer prepare IARs or their preparation would be inadequate. Id.

7/ Such candid evaluation is particularly necessary in a large decentralized corporation such as Leaseway, where central management may be unaware of the activities of lower level personnel or their subsidiaries.

If IARs can be obtained by the IRS routinely through an administrative summons without either prior in camera inspection or any regard for their confidential nature, they will no longer be afforded confidential treatment. The IRS, and perhaps other government agencies and private litigants as well, will then have ready access to the IARs. Business management will no longer be assured that IARs will only be reviewed by select employees and used for their intended salutory purposes.

As a consequence, business will either be deterred from preparing them or will prepare them inadequately.[8/] See Block

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8/ However, if this Court affirms the decision in United States v. Arthur Young & Co., 677 F.2d 211 (2d Cir. 1982), cert. granted, 51 U.S.L.W. 3611 (U.S. Feb. 22, 1983) (No. 82-687), internal audits may then be undertaken by outside accounting firms instead of internally, in order to protect their confidentiality and achieve their objectives, at substantial additional expense and inconvenience to businesses, and with a loss of ready access to inside information.

& Barton, supra p. 10 at 8-17; Upjohn, 449 U.S. at 393 n.2. Voluntary corporate compliance with the law and supervision of operational efficiency will no longer be undertaken with its present vigilance and vigor. See Murphy, supra p. 10, at 494-497. The public benefits will be eroded.

II. This Court Should Decide At This Time What Protection Should Be Given To Internal Audit Reports.

A. Substantially Similar Questions Are Before This Court In United States v. Arthur Young And El Paso Co. v. United States.

Questions substantially similar to the question presented in this petition are before this Court in Arthur Young and United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3400 (U.S. Nov. 23, 1982) (No. 82-176).

The question presented in Arthur Young is whether tax accrual worksheet papers prepared for a corporation by outside

accountants are subject to a summons issued by the IRS under 26 U.S.C. § 7602. Arthur Young, 677 F.2d at 211. The Second Circuit Court of Appeals held that although the documents are relevant for purposes of 26 U.S.C. § 7602, a work product privilege protects the documents from a summons unless the IRS makes a sufficient showing to overcome the privilege. Id. at 219.

The question presented in El Paso is whether tax pool analyses prepared, as in the instant case, by internal corporate personnel in consultation with in-house counsel and verified by outside accountants may be summoned by the IRS under 26 U.S.C. § 7602. El Paso, 682 F.2d at 533. The Fifth Circuit Court of Appeals upheld the power of the IRS to summon the documents. Id. at 545.

The documents in Arthur Young were prepared by outside accountants and the documents in El Paso were verified by outside accountants (although prepared internally within the corporation). However, the question presented in both cases is very similar to the question presented in this petition. All three cases present the question of the IRS's authority under 26 U.S.C. § 7602 to compel a taxpayer to surrender confidential documents prepared to foster compliance with law and encourage operational efficiency.

The questions presented in this petition, Arthur Young and El Paso have a common basis and are thus similar. This Court should grant this petition in order to decide the question presented herein in conjunction with Arthur Young and El Paso.[9/]

9/ Petitioners suggest that the Court should either (1) consolidate this case (continued)

B. This Court Should Resolve The Dispute In The Case Law Concerning Limitations On Discovery Of Confidential Documents By An IRS Administrative Summons.

The case law concerning limitations on discovery of confidential documents through administrative summons issued by the IRS is unsettled and the issue should be resolved. The courts have interpreted the "relevance standard" of 26 U.S.C. § 7602 in two

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9/ (continued) with Arthur Young or (2) grant this petition and schedule oral argument at the same time as oral argument in Arthur Young. Petitioners make this request because the Court's decision in Arthur Young may dictate Leaseway's corporate policy of internal auditing. Should the Court affirm the Second Circuit's decision and deny this petition, Leaseway may be forced to employ external auditors to perform its internal auditing activities so as to protect the IARs' confidentiality and hence their utility to Leaseway although, as indicated above, this procedure is expensive and less satisfactory. At the very least it would be in order to defer action on this petition, as was done in El Paso, pending disposition by this Court of Arthur Young.

different manners.[10/] In United States v. Coopers & Lybrand, 550 F.2d 615, 619-620 (10th Cir. 1977), United States v. Matras, 487 F.2d 1271, 1275 (8th Cir. 1973), United States v. Harrington, 388 F.2d 520, 523 (2d Cir. 1968), and United States v. First Chicago Corp., 79-1 U.S.T.C. ¶ 9111 (N.D. Ill. 1978), the courts held that there is some limitation on the summons power of the IRS. These cases generally have held that the IRS must have a "reasonable expectation" that the summoned documents are relevant to the taxpayer's returns. Coopers & Lybrand, 550 F.2d at 619; Harrington, 388 F.2d at 524; Matras, 487 F.2d at 1274; First Chicago Corp., 79-1 U.S.T.C. at ¶ 9111, p. 86,037. In First Chicago Corp., the court applied the reasonable expectation test and held that many of

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10/ The statute provides that the IRS can only summon documents "which may be relevant" to the tax audit. 26 U.S.C. § 7602(1)(1976).

the taxpayer's IARs were not relevant. The court stated:

> This Court has not found documents relevant which are exclusively discussions of internal operating procedures or of the efficiency with which procedures are being followed. Nor have we found relevant reports which are spot-checks of individual departments within respondent, but which make passing references to individual, de minimis transactions.

79-1 U.S.T.C. at ¶ 9111, p. 86,037.

However, in Noall, 587 F.2d at 125, Arthur Young, 677 F.2d at 219, and El Paso, 682 F.2d at 544, the courts held that the IRS summons authority is virtually limitless once relevancy, no matter how remote, has been established. These cases generally have held that if IARs merely "might have thrown light upon the correctness of the taxpayer's returns" then they were within the IRS summons power. Id. In Noall the court applied the "might have thrown light upon" test and held that the taxpayer's IARs were relevant. The court stated:

> Clearly the purposes of the internal audit include the detection of overstatements or understatements of revenues or expenses, and of identifying accounting procedures that would lead to these. If the internal auditors have ascertained an understatement of revenues or an overstatement of expenses, this plainly might throw light on the correctness of the returns.

587 F.2d at 126.

Thus, the courts have differed in their interpretation of the relevancy standard of 26 U.S.C. § 7602. In First Chicago Corp. and Noall, the two leading cases concerning IARs,[11/] the courts reached conflicting results. This Court should interpret the relevancy standard in light of the public policy considerations and resolve the conflict in the application of that standard to IARs.

11/ The only other cases concerning IARs are United States v. Riley, 80-1, U.S.T.C. ¶ 9157 (N.D. Ill. 1980), and United States v. Arthur Andersen & Co., 474 F. Supp. 322 (D. Mass. 1979), appeal dismissed, 612 F.2d 569 (1979), cert. denied, 449 U.S. 1021 (1980).

C. The Confidentiality Of Internal Audit Reports Now Requires Protection.

The IRS has begun to routinely seek review of IARs during corporate tax audits. The IRS "Audit Manual," as amended in 1980, now directs the IRS auditors to review a taxpayer's "internal management reports" (IARs) during the course of an audit. II Internal Revenue Manual (Audit) (CCH) Ch. 600, § 622 (2)(a) (1980).[12/] Indeed, it is only during the most recent audit of Leaseway that the IRS requested Leaseway's IARs. R. at 79. In previous audits the IRS expressed no interest in Leaseway's IARs. Id. Audit Case Manager James Simeo stated that the IRS, pursuant to the Audit Manual, desired to review IARs in the course of audit of a taxpayer such as Leaseway. R. at 12-13.

12/ See also "Regional Commission Memorandum" from the Central Regional Office of the IRS, "Management of Large Cases" § 5.02(2) (directing auditors to review IARs).

If the Court does not now protect IARs, the consequence will be that the IRS's recent change in policy directed to reviewing IARs routinely will be enshrined. The IRS will then have blanket authority to obtain IARs through an administrative summons without regard either to the sensitivity of such documents or a showing of a realistic potential of relevance. Businesses will either stop preparing them, "pull their punches" in preparing them or have them prepared by outsiders. In any such event, the public benefits derived from IARs will be permanently lost.

III. The Balance Between Government Access To Information And The Confidential Integrity Of IARs May Readily Be Struck By Employing Established In Camera Court Proceedings.

Where, as here, a legitimate claim of confidentiality is raised, the trial court (if the matter cannot be resolved at the

administrative level) directly or through a clerk or special master (see Rules 53 and 77(b) of the Federal Rules of Civil Procedure) can readily resolve the matter. See, e.g., First Chicago Corp., 79-1 U.S.T.C. at ¶ 9111. In this fashion, a weighing of the competing considerations will be effected. The objective of both public policies will be achieved.

In the situation now before this Court, involving a recently asserted IRS policy[13/] to review IARs without a realistic showing of relevancy, it is an abdication of judicial responsibility to permit the administrative discovery of confidential documents without weighing on the scale of competing considerations the public policy underlying the confidentiality of IARs.

13/ II Internal Revenue Manual (Audit) (CCH) Ch. 600, § 622(2)(a) (1980).

The trial court should be required to balance the chance that such documents (which at best here are only remotely and tenuously relevant) will lead to helpful information against the detriment to be suffered if the confidential information is compromised. Such determinations are ideally suited for the trial court's in camera procedures.

IV. The Court Below Ignored The Compelling Reasons Of Public Policy Which Require Some Protection For Leaseway's Internal Audit Reports.

A. The Court Below Made No Mention Of The Public Benefits Derived From Leaseway's Internal Audit Reports Procedure.

The Sixth Circuit Court of Appeals in its memorandum decision and order made no mention of the public benefits derived from Leaseway's IAR procedure. The court merely held that Leaseway's IAR's were relevant to the tax audit and summarily distinguished Arthur Young without discussing the policy issue. App. at A-10 - A-12.

Leaseway's use of IARs produces substantial public benefits. As discussed above, their use fosters compliance with the law and enhances operational efficiency. R. at 144, 148-149.

B. The Internal Revenue Service Did Not Have A Reasonable Expectation That Leaseway's Internal Audit Reports Were Relevant.

In order for Leaseway's IARs to be subject to the IRS's administrative summons power, the IRS must have had a reasonable expectation that the IARs were relevant to the audit. Coopers & Lybrand, 550 F.2d at 619; Matras, 487 F.2d at 1271; Harrington, 388 F.2d at 524; First Chicago Corp., 79-1 U.S.T.C. at ¶ 9111, p. 86,037. The burden of proof was on the IRS to make an affirmative showing in the District Court that it had a reasonable expectation that the IARs were relevant. United States v. Powell, 379 U.S. 48, 51, 57-58 (1964).

The IRS clearly lacked such reasonable expectation. George Kast, the IRS audit Group Manager, stated that the IRS had no expectation that relevant material was contained in the IARs. R. at 199. Moreover, Case Manager James Simeo stated that he did not know what was in the IARs.[14/]

14/ Simeo testified at the district court hearing:

EXAMINATION BY MR. MANDEL:

Q. Mr. Simeo, you have no idea what those internal audit reports contain, do you?

A. (Mr. Simeo) I have no idea.

Q. You have no idea if they contain information which is relevant, do you, and you have no idea if they contain information that is material, do you?

A. Until we see them.

Q. The basis for requesting it was the manual then, and Mr. Kast's memo; is that not correct?

(continued)

The court below incorrectly reasoned that since there is a reasonable expectation that the "typical IAR" is relevant (presumably in all cases) then there must be a reasonable expectation that Leaseway's IARs are relevant. App. at A-6. The court below completely ignored the strong and clear statements in the record that the IRS did not have a reasonable expectation that Leaseway's IARs were relevant. Id.; R. at 45-46, 199.

14/ (continued)

A. And the possibility that they would contain relevant material.

Q. You were hoping they would contain relevant material; is that right?

A. We don't know. We have to see them first.

R. at 45-46.

C. Where The Internal Revenue Service Did Not Have A Reasonable Expectation That Leaseway's Internal Audit Reports Were Relevant, The Compelling Reasons Of Public Policy Should Protect Them.

This Court has stated that it has:

> ...consistently construed congressional intent to require that if the [IRS] summons authority claimed is necessary for the effective performance of congressionally imposed responsibilities to enforce the tax Code, that authority should be upheld absent express statutory prohibition or substantial countervailing policies.

United States v. Euge, 444 U.S. 707, 711 (1980). (Emphasis supplied.)

There are substantial countervailing policies to limit the IRS summons authority where the IRS admits that it lacks a reasonable expectation that IARs are relevant to a tax audit. By so limiting the IRS summons authority, this Court would not be eroding

congressional intent, but would merely be interpreting 26 U.S.C. § 7602 in a manner to comport with the compelling reasons of public policy which protect IARs.

IARs may be properly subject to the IRS administrative summons authority in cases where the IRS has a reasonable expectation that IARs are relevant. However, in cases such as this one, where the IRS lacks such a reasonable expectation, the compelling reasons of public policy should protect the IARs from IRS administrative summons authority. The court below ignored the compelling reasons of public policy which protect the confidentiailty of Leaseway's IARs and incorrectly held (without any supporting evidence) that the IRS had a reasonable expectation that Leaseway's IARs were relevant.

Since the record clearly shows that the IRS lacked a reasonable expectation that Leaseway's IARs were relevant, the compelling

reasons of public policy should exclude them from the IRS summons authority. This Court should grant this petition and construe 26 U.S.C. § 7602 accordingly.

CONCLUSION

Compelling reasons of public policy require that some protection be given to the IAR procedure so as to preserve the benefits which it creates. The use of IARs produces substantial public benefits because voluntary compliance with the law by businesses is fostered and operational efficiency of businesses is enhanced. The public benefits from the use of IARs will disappear or be seriously eroded if this Court does not give some degree of protection to their confidentiality.

There are three strong reasons why this Court should decide at this time what protection should be given to the confidentiality

of IARs. First, Leaseway could be unfairly prejudiced should this Court deny this petition and decide the substantially similar questions now before this Court in Arthur Young and El Paso. Second, there is conflict in the case law concerning IARs which should now be resolved. Third, if this Court does not agree to hear this matter the IRS's new policy routinely to review IARs during the course of an audit will be blessed as standard procedure.

Where the IRS lacks a reasonable expectation that IARs are relevant to an audit, the compelling reasons of public policy should protect their confidentiality. The IRS virtually admits that it did not have a reasonable expectation that Leaseway's IARs were relevant to its audit. Public policy should protect their confidentiality.

For the foregoing reasons, Petitioners the Leaseway Transportation Corp. and Raymond

J. Rehor respectfully pray that this Petition for a Writ of Certiorari be granted.

Respectfully submitted,

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APPENDIX A

FILED
April 19, 1983
John P. Hehman,
Clerk

No. 81-3726

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

UNITED STATES OF AMERICA, et al.,

Petitioners-Appellees,

v.

LEASEWAY TRANSPORTATION CORP., et al.,

Respondents-Appellants.

ORDER

NOT RECOMMENDED FOR FULL-TEXT PUBLICATION

Sixth Circuit Rule 24 limits citation to specific situations. Please see Rule 24 before citing in a proceeding in a court in the Sixth Circuit. If cited a copy must be served on other parties and the Court.

This notice is to be prominently displayed if this decision is reproduced.

Before: MERRITT, KENNEDY and MARTIN, Circuit Judges.

Appellant Leaseway Transportation Corp. (Leaseway), a large trucking and leasing company, refuses to comply with an Internal Revenue Service (IRS) summons requesting that

it turn over internal audit reports (IARs).[1/] Leaseway maintains that the documents were not properly discoverable under the IRS summons power, 26 U.S.C. § 7602, Internal Revenue Code of 1954,[2/] either because IARs

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1/ 147 IARs exist for the tax years 1975-1978. The IRS has agreed to request disclosure of only four (4) reports and if, upon examination, they reveal nothing pertinent to the investigation, no further IARs will be summoned.

2/ 26 U.S.C. § 7602 provided:

> Examination of books and witnesses
>
> For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized --
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry; (2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any

(continued)

are irrelevant to the investigation or, in the alternative, are the privileged work-product of internal auditors. The IRS moves to compel production of the documents pursuant to 26 U.S.C. § 7604[3/] and, finding

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2/ (continued)
person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

3/ 26 U.S.C. § 7604 provides in pertinent part:

Enforcement of summons

(a) Jurisdiction of district court.--If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to (continued)

that the documents were neither irrelevant nor privileged, the United States District Court for the Northern District of Ohio entered an order granting the petition for enforcement of the summons.[4/] We affirm.

3/ (continued)
compel such attendance, testimony, or production of books, papers, records, or other data.

(b) Enforcement.--Whenever any person summoned under section 6420(e)(2), 6421(f)(2), 6424(d)(2), or 7602 neglects or refuses to obey such summons, or to produce books, papers, records, or other data, or to give testimony, as required, the Secretary or his delegate may apply to the judge of the district court or to a United States commissioner for the district within which the person so summoned resides or is found for an attachment against him as for a contempt. It shall be the duty of the judge or commissioner to hear the application, and, if satisfactory proof is made, to issue an attachment, directed to some proper officer, for the arrest of such person, and upon his being brought before him to proceed to a hearing of the case; and upon such hearing the judge or the United States commissioner shall have power to make such order as he shall deem proper, not inconsistent with the law for the punishment of contempts, to enforce obedience to the requirements of the summons and to punish such person for his default or disobedience.

4/ The enforcement order has been stayed pending appeal.

In July of 1979, the IRS began its audit of the consolidated tax returns of Leaseway and its subsidiaries for the tax years 1975-1978. The IRS classified the audit as a "large case" based upon Leaseway's size and scope of operations. IRS Agent James Simeo, case manager for the audit, made the decision that any IARs which had been prepared by Leaseway for the tax years in question would be examined.[5/]

Leaseway relies upon United States v. Powell, 379 U.S. 48, 57-8 (1964), to argue that the District Court erred in enforcing the summons because the IRS had failed to satisfy the prerequisites to obtaining enforcement.

5/ The IRS contends that its "Controlled Examination Program" casebook for large cases suggests, if not requires, that internal audit reports be examined. Also, the post-audit critique prepared by the case manager of the previous Leaseway audit recommended that future audits include examinations of the company's IARs.

> [The IRS] must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the commissioner's possession, and that the administrative steps required by the Code have been followed. . . .

The IRS is conducting this investigation for the legitimate purpose of verifying appellant's tax returns for the years in question. It is not contested that the administrative steps required by the Code have been followed. Appellant primarily maintains that the IARs are irrelevant because they are operational in nature, do not provide information as to specific transactions affecting tax liability, and were not used in the preparation of appellant's tax returns. In other words, because the objective of an internal audit is to survey operational efficiencies of a company, the typical IAR, it is argued, would be irrelevant to determining the accuracy of appellant's tax returns. We disagree. In United States v. Noall, 587 F.2d 123, 126 (2d

Cir. 1978), cert. denied, 441 U.S. 923 (1979), the Second Circuit stated:

> Clearly the purposes of the internal audit include the detection of overstatements or understatements of revenues or expenses, and of identifying accounting procedures that would lead to these. If the internal auditors have ascertained an understatement of revenue or an overstatement of expenses, this plainly might throw light on the correctness of the returns. We find no significance in the point, stressed by appellant, that the internal audit reports and related work papers were not used in preparing [the company's] income tax returns.

The standard of relevance is whether the information sought "might throw light upon" the inquiry. Foster v. United States, 265 F.2d 183, 186-187 (2d Cir.), cert. denied, 360 U.S. 912 (1959).[6/] The showing must be one

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6/ Accord, United States v. City National Bank & Trust Co., 642 F.2d 388, 389 (10th Cir. 1981); United States v. Wyatt, 637 F.2d 293, 300 (5th Cir. 1981); United States v. Richards, 631 F.2d 341, 345 (4th Cir. 1980); United States v. Freedom Church, 613 F.2d 316, 321 (1st Cir. 1979); United States v. (continued)

of a realistic expectation, rather than an idle hope, that something pertinent to the investigation may be discovered. United States v. Harrington, 388 F.2d 520, 524 (2d Cir. 1968). See also Wyatt, supra at 300-301; Matras, supra, at 1274. Since there exists a realistic expectation that something discovered in the IARs might throw light upon this investigation into the accuracy of Leaseway's tax returns for the years 1975-1978, the District Court did not err in holding that the requested documents are relevant under Powell, supra.

Leaseway next argues that the information requested is not discoverable under Powell, supra, because it is already in the

---

6/ (continued)
Matras, 487 F.2d 1271, 1274 (8th Cir. 1973); United States v. Turner, 480 F.2d 272, 279 (7th Cir. 1973); United States v. Ryan, 455 F.2d 728, 733 (9th Cir. 1972); United States v. Egenberg, 443 F.2d 512, 515 (3d Cir. 1971); United States v. Shlom, 420 F.2d 263, 265 (2d Cir. 1969), cert. denied, 397 U.S. 1074 (1970).

possession of the IRS. In other words, since the IARs were compiled from underlying documentation which is already in the possession of the IRS, Leaseway contends it is not obligated to tender the information to the IRS in the compiled form. Again, we disagree. The fact that the IRS has the underlying data from which it could deduce the statistics contained in the IARs does not preclude it from requesting the disclosure of compilations which have previously been prepared. The IRS need not duplicate the efforts of Leaseway. To hold otherwise would be to invite taxpayers to surrender to the IRS only the minimum amount of underlying documentation available and to require the IRS to then compile the data into usable form, even though such compilations already exist. Such a limited discovery rule would retard the policy interest of effective tax law enforcement and revenue collection. Moreover, an internal audit report, in

contrast with the underlying data comprising it, is additionally valuable in that it may pinpoint areas where record keeping was inadequate and further investigation is required.

Citing United States v. Arthur Young & Co., 677 F.2d 211 (2d Cir. 1982), cert. granted, 51 U.S.L.W. 3597, 3611 (U.S. Feb. 22, 1983) (No. 82-687), Leaseway finally argues that the IARs are protected by a qualified work-product privilege extending to the work of internal auditors. In Arthur Young the Second Circuit concluded that the conflict between the interest in the enforcement of tax laws (requiring that thorough investigations be conducted) and the interest in ensuring the maintenance of fair and honest markets in securities transactions (requiring that management feel free to cooperate with their auditors without fear that confidential information will be disclosed to the IRS) required that court to

fashion protection for the work that independent auditors, retained by publicly owned companies to comply with the federal securities laws, put into preparation of tax accrual work papers. By analogy to the attorney's work-product privilege of Hickman v. Taylor, 329 U.S. 495 (1947), the Arthur Young court created a work-product privilege to protect tax accrual work papers of outside auditors and, thus, the "independent auditing process." Since the Supreme Court has accepted certiorari in Arthur Young and it is factually distinguishable from this case, we need not pass upon the correctness of its holding.

We note, however, that while creating a privilege with respect to tax accrual work papers, the Second Circuit declined in the first half of its opinion to extend the privilege to external audit work papers. Citing its earlier decis[illegible] Noall, supra, the Second Circuit wrote:

> AY [Arthur Young] has advanced no persuasive argument to distinguish between the usefulness of the internal audit procedure at issue in Noall and the external audit at issue here.

Arthur Young, supra, at 216. In Noall, supra, the Second Circuit affirmed an order of the district court which enforced an IRS summons requiring the executive vice president of the taxpayer corporation to appear and produce for examination all internal audit reports and related work papers for the fiscal years in question. Thus, even in a jurisdiction which recognizes a judicially created accountant's work-product privilege, internal audit reports were not considered privileged documents.

Accordingly, the judgment of the District Court is AFFIRMED.

ENTERED BY ORDER OF THE COURT

/s/
Clerk

5JET5H

APPENDIX B

FILED
1981 OCT 15
PM 3:30

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

UNITED STATES OF AMERICA, et al. Petitioners, v. LEASEWAY TRANSPORTATION CORP., et al. Respondents	Case No. C80-1116 MEMORANDUM

GREEN, S.J.:

The Internal Revenue Service (IRS) brings this action pursuant to 26 U.S.C. § 7604 to enforce its summons for production of internal audit reports of the Leaseway Transportation Corp. (Leaseway).

A hearing on the petition was held June 10 and 11, 1981. After considering the testimony, the arguments and briefs of counsel, the Court makes the following findings of fact and conclusions of law.

Leaseway is a Cleveland-based corporation engaged in the contract leasing of trucking equipment and warehousing. It conducts business on a nationwide basis through 189 subsidiaries.

In July, 1979, the IRS began its audit of the consolidated tax returns of Leaseway and its subsidiaries for tax years 1975 through 1977. At Leaseway's request, the tax year 1978 was added to the audit period.

Because of Leaseway's size and scope of operations, the IRS classified the audit as a "large case" and applied established management techniques and standards for "regionally controlled" large cases to the audit.

IRS Agent James Simeo was designated "case manager" for the audit. As such, he had overall responsibility for managing the audit. Agent Kenneth J. Robins was appointed "team audit coordinator" of the IRS staff while on site at the Leaseway headquarters. Robins was familiar with Leaseway's op-

erations and structure, as he had coordinated the audit of Leaseway's returns for the tax years 1973 and 1974.

At the commencement of the audit, Simeo made the decision that any internal audit reports which had been prepared by Leaseway would be examined as part of the audit. This decision was not wholly discretionary on Simeo's part. The IRS "Controlled Examination Program" casebook for case managers strongly suggests, if not requires, that internal audit reports (IARs) be examined as part of any audit. Further, Simeo had read the post-audit critique prepared by the case manager of the previous Leaseway audit; the critique plainly recommended that future audits of the corporation include examination of the company's internal audit reports.

In mid-October, 1979, Simeo visited the Leaseway headquarters where the audit team had been working. While there, he directed Robins to examine Leaseway's IARs. On

October 17, Robins issued an Information Document Request (IDR), the 21st in a series of many such requests. IDR 21 asked for a list of all internal audit reports prepared by the corporation or any of its subsidiaries during the audit years in question.

In an undated, unsigned reply to IDR 21, the company responded to the request by saying:

> We believe the internal audit reports requested are not necessary to the accurate determination of Leaseway's consolidated federal income tax liability since they are primarily reports which recommend to management ways to improve operating efficiencies. Consequently, we respectfully refuse to honor this request.

Although the audit had been under way for some time, on November 21, 1979, a "pre-audit" conference was held between the IRS team and the Leaseway officials involved. Representing Leaseway, among others, was Raymond J. Rehor, the corporation's Vice-President for Taxes, and Alan Kalous, the manager of federal taxes. Simeo advised

Rehor and Kalous that IARs would be requested during the audit.

In January, 1980, Simeo again visited the Leaseway site to discuss the progress of the audit with Robins. During the discussion, Simeo discovered that Robins had made no further efforts to obtain the list of IARs which had been initially requested in IDR 21. Simeo instructed Robins to make every effort to secure such a list.

As a result of subsequent discussions with Leaseway management, Robins secured a list of those Leaseway subsidiaries subjected to internal audits during the years in question. The list indicates that 15 subsidiaries were audited in 1975; 35 in 1976; 49 in 1977; and 48 in 1978; or a total of 147 internal audits during the tax years being audited by the IRS.

After receiving the list, Robins and Simeo agreed that instead of requesting production of all 147 IARs, a supplemental IDR

would be issued requesting only four. If the four specific reports disclosed nothing of relevance to the audit, the agents agreed, no further IARs would be sought. IDR 163 was issued on January 25, 1980, requesting IARs for four specific subsidiaries audited in 1977 and 1978.

On February 14, Rehor visited Simeo and delivered a letter declining to comply with IDR 163. In the letter and during their conversation, Rehor told Simeo that the IARs concerned operational matters only, and contained no information having an effect on Leaseway's tax liability.

Simeo then asked Rehor to provide the IRS with any written manuals or directives to Leaseway's internal audit staff. IDR 176 was subsequently issued to formalize that request. No response was made to IDR 176.

The Leaseway executives involved in the audit testified that Robins expressed doubts to them regarding the necessity to examine

the IARs. The executives testified that Robins was reluctant to issue IDRs regarding the reports and did so only because of pressure from Simeo. Rehnor testified that when Robins served him with the summons, Robins apologized, and said he was acting under direct orders from Simeo.

In his testimony, Simeo confirmed that Robins was reluctant to pursue the issue of the IARs, but changed his mind after the summons was served. Robins issued and served the summons on April 8, 1980.

On April 21, Rehor met with Donald Heidler, Chief of the Examination Branch of the IRS Cleveland District Office. Rehor testified that at the meeting he asked Heidler why Leaseway was being singled out, i.e., why other Cleveland-based companies of similar size were not being asked to produce IARs. Rehor testified that Heidler's response was to the effect that Leaseway was a

good "test case," and that IARs would not be aggressively sought from other companies.

Rehor also testified that Heidler indicated particular interest in Leaseway's IARs because the company "had turned up relatively clean in the past audits and the government really hasn't gotten much money out of Leaseway in the past."

During his testimony, Heidler was not questioned regarding what was said at the April 21 meeting. But Heidler did testify that he was of the impression that large case audits generally yielded "around" 30 per cent additional revenue as a percentage of taxes originally paid. Heidler also testified that Leaseway was "below average" in the amount recovered after audits. The IRS did not challenge Rehor's testimony that the permanent additional tax dollars paid by Leaseway after audits for years 1971 through 1978 was about six-tenths of one per cent.

In July, 1980, Simeo and his staff met with Rehor and his staff to discuss the status of the audit. It was agreed that the audit was nearly completed and that only three issues remained. The first was the matter of the IARs. The second was a question of salvage value of specific equipment. The third was a question of whether certain taxes were to be paid to the government of Canada or to the United States. Simeo instructed Richard Kaiser, the new team audit coordinator who succeeded Kenneth Robins who had passed away, to begin writing his report. It is not clear from the testimony whether such a report was written, but Simeo testified that by July, 1980, the field work for the audit was completed.

This action to enforce the summons for the IARs followed. The parties engaged in limited discovery prior to the hearing.

Title 26, United States Code, § 7602 reads, in part:

> For the purpose of ascertaining the correctness of any return, . . . the Secretary . . . is authorized ---
>
> (1) To examine any books, papers, records, or other data which may be relevant to such inquiry;
>
> (2) To summon . . . any officer or employee [of the taxpayer] . . . to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, . . . as may be relevant or material to such inquiry; . . .

Title 26, United States Code, § 7604 reads, in part:

> (a) If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, records, or other data.

The parties agree that the foregoing sections are to be considered in light of United States v. Powell, 379 U.S. 48 (1964). The parties further agreed that, pursuant to Powell, the IRS need not show probable cause

to enforce the summons, but must satisfy four criteria.

First, it must appear that the information sought is for a valid purpose, i.e., not for the purpose of harassment. Second, the IRS must show that the information sought is relevant to that purpose. Third, the government must show that the information is not already within the possession of the IRS. Fourth, it must appear that the administrative steps required by the IRS prior to the issuance of the summons have been followed. While the IRS has the burden of showing the latter three elements, the taxpayer has the burden of proving any improper motive. United States v. Powell, supra.

Leaseway does not seriously contest that the IRS has followed the administrative procedures required to issue the summons. While the issue of procedural regularity was raised in the company's pre-hearing brief, Leaseway made no inquiry at the hearing with regard to

the issue, and has not discussed the matter in its post-hearing briefs.

Similarly, Leaseway does not seriously contest that the IARs sought are not already within the possession of the IRS. Like the matter of procedure, the issue was raised in pre-hearing briefs, but not mentioned in post-hearing argument.

There was testimony at the hearing to the effect that the IRS may have such information as may be contained in the IARs from other sources. But the testimony was plain that the IRS does not have the specific IARs which were summoned.

Such a determination disposes of the issue. "Courts applying the 'already-in-possession' portion of the Powell test have applied a literal interpretation." First Chicago Corp. v. United States, 79-1 U.S.T.C. ¶ 9111 (N.D.Ill., 1979). The simple question is whether the actual documents summoned are within the possession of the IRS.

United States v. Arthur Andersen and Co., 474 F. Supp. 322, 330 (Mass., 1979). The simple answer is that the IARs are not in the possession of the IRS.

Leaseway's defense to the summons thus rests upon two allegations. First, Leaseway argues, the summons was issued for an improper purpose, i.e., harassment. Second, the company claims the IARs are not relevant to the purposes of the audit.

Leaseway's first argument is based on its allegation that the government is "frustrated." Because the IRS "has never gotten any money out of Leaseway," as a result of its audits, the IRS needs a "moral victory" with respect to the IARs.

In support of this theory, Rehor testified that he attended a seminar for corporate tax executives at which a former IRS commissioner spoke. According to Rehor, the former commissioner indicated that the government's policy was to request IARs, but not

to seek them aggressively if the taxpayer declined to deliver them.

Rehor also testified that he contacted tax executives of other large Cleveland-based corporations, and learned from them that the IRS had not requested IARs when auditing the tax returns of those other corporations.

Finally, after pointing to Heidler's comments, Rehor and other Leaseway executives testified that Agent Robins frequently expressed reluctance to seek the IARs, and quoted Robins as saying he did not need the IARs to complete the audit.

Heidler testified, however, that of the four companies mentioned, only two were audited pursuant to the "controlled case" criteria by which Leaseway was audited. Heidler also testified that the IRS requested IARs from both of those companies, and the companies provided the reports. Thus, there is no basis for a claim of harassment based on any disparity of treatment.

The Court does not find that the statements of the former IRS Commissioner nor those of Agent Robins provide an indication of harassment. A change in policy by the IRS after a commissioner leaves office is not indicative of harassment of an individual taxpayer. Nor does disagreement between an agent and his superiors give rise to an inference of harassment.

Finally, Heidler's comment that Rehor should not worry; that "the government had never gotten any money out of Leaseway," may be interpreted in two ways. One would lead to a finding of frustration and retaliation, as the company claims. The other would be one of reassurance, a statement to Rehor that, as far as Heidler was concerned, Leaseway had and was accurately reporting its tax liability and that production of the IARs would not lead to any financial loss to the company.

The Court finds that even if Heidler's statement was evidence of harassment or improper motive, the statement does not rise to the level of "substantial proof" required to show abuse of the Court's process. United States v. Powell, surpa, at 379 U.S. 58; United States v. Kessler, 338 F. Supp. 420 (S.D.Ohio, 1972). The claim of harassment or improper purpose has not been proved.

Leaseway's final claim is that the IARs sought are not relevant and material to the determination of the accuracy of its tax returns. It claims that the IRS has not shown that the reports will contain matters related to the company's tax liability, but rather deal only with internal policies and controls of the corporation.

In United States v. Powell, supra, at 379 U.S. 57, the Court said that the extent of the IRS' "inquiry must not be 'limited . . . by forecasts of the probable result of the investigation.'" The IRS, the Court said:

> . . . has the power of inquisition, if one chooses to call it that, which is not derived from the judicial function. It is more analogous to the Grand Jury, which does not depend upon a case or controversy for power to get evidence but can investigate merely upon suspicion that the law has been violated or even just because it wants assurance that it has not.

In the abstract, such language would provide the IRS with the authority to demand records which in any way deal with a taxpayer's finances. The concrete facts in this case lead to the same result.

As part of its case, Leaseway called Dr. Walter G. Kell, professor of accounting at the University of Michigan. Dr. Kell, a certified public accountant, specializes in the area of audits, and has served on professional committees which have established recognized national audit standards.

Dr. Kell testified that at the request of Leaseway management, he examined the corporation's internal audit operations and the

manner in which its tax returns were prepared. He then made a cursory examination of ap roximately 140 of Leaseway's IARs for the tax audit period, then selected eight IARs for detailed review.

Dr. Kell testified that the IARs were almost entirely operational in character. That is, the reports dealt almost exclusively with internal controls, compliance with policies, and efficiencies of the respective subsidiaries.

Dr. Kell did testify, however, that the reports contained "reference to individual transactions engaged in by the specific subsidiary," and contained "one or two correcting entries relative to an incorrect reversal of an entry or in correct recording of an entry." The latter, Dr. Kell said, "could conceivably have an impact on the financial statement" from which the tax return was prepared.

Dr. Kell also testified that the IARs he examined contained "timing adjustments." That is, adjustments as to the date a particular transaction would be posted by the subsidiary's bookkeepers. It was conceded that a timing adjustment generally had no effect on the permanent tax liability of the corporation; an adjustment might mean that the tax would be paid for one year rather than for another. But Dr. Kell testified that the timing of an entry could have an effect on the accuracy of a particular tax return.

Dr. Kell also testified that one IAR he examined suggested that a subsidiary keep more detailed records to substantiate ledger entries. Since the IRS examines substantiating records for ledger entries as part of an audit, whether the company kept sufficient records might tend to shed light on the correctness of the return.

The question for this Court to decide is not whether the IARs sought are relevant and material to the audit. "[T]his Court is to decide only whether the reports may be be [sic] relevant." United States v. Riley Co., 80-1 U.S.T.C. ¶ 9157 (N.D.Ill, 1980) (emphasis in original).

The Court concludes from the testimony that the IARs summoned by the IRS may, in fact, shed light on the correctness of the Leaseway tax returns. The IARs may show that Leaseway has correctly reported its tax liability. They may show that it has not. They may show nothing of value to the IRS. But the IRS is entitled to examine them.

The Court notes the decisions of other courts which have examined the issue of whether IARs are material to a tax audit, and have reached the same result. United States v. Noall, 587 F.2d 123 (C.A. 2, 1978); United States v. Arthur Andersen and Co., supra; United States v. Riley Co., supra.

The Court concludes that Leaseway has not shown that the summons issued in this case was for an improper purpose. The IRS has shown that proper procedures were followed and that the information sought is not already in its possession. Finally, a showing was made that the information summoned may shed light on the correctness of Leaseway's consolidated tax returns.

An order will be entered granting the petition for enforcement.

/s/
United States Senior District Judge

5JET5D

APPENDIX C

C-1

No. 81-3726

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

UNITED STATES OF AMERICA, et al.,

Petitioners-Appellees,

v.

LEASEWAY TRANSPORTATION CORP., et al.

Respondents-Appellants.

Before: MERRITT, KENNEDY and MARTIN, Circuit Judges.

The Court not having favored rehearing en banc in this case, the petition for rehearing is referred to our panel for disposition.

Upon consideration, IT IS ORDERED that the petition for rehearing be and it hereby is DENIED.

ENTERED BY ORDER OF THE COURT

/s/

5JET5F

APPENDIX D

Survey of Internal Auditing, 1979

Prepared by:

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Auditing, Inc.
249 Maitland Avenue
Altamonte Springs, Florida 32701
(305) 830-7600

The figures reported in the chart below are the percentages of respondents that in 1979 audited the activities or functions listed in the left hand column.

Activities or Functions Audited	Size of Business			
	Small	Medium	Large	Total
Advertising	28.3%	36.0%	53.0%	41.2%
Billing/Collecting	82.1	86.3	87.6	85.8
Capital Assets Accounting	75.5	78.9	88.1	81.9
Construction Projects	40.6	55.9	76.8	60.8
Consumer Compliance	12.3	18.6	31.4	22.3
Contracts	40.6	57.1	75.1	60.6
Corporate Ethics	41.5	45.3	57.3	49.3
Cost Estimations	21.7	32.9	37.3	32.1
Electronic Data Processing	70.8	80.1	92.4	83.0
Energy Audit	6.6	12.4	17.8	13.3
FCPA Compliance	40.6	52.2	74.6	58.6
Financial	88.7	93.2	96.2	93.4
Government Regulations	30.2	54.7	68.1	54.4
Inventory Planning and Control	56.6	63.4	71.4	65.0
Insurance Programs	34.9	49.1	63.8	51.8
Management Information Systems	52.8	59.6	77.3	65.3
Manufacturing/Production	36.8	41.6	57.3	46.9
Marketing/Sales	40.6	41.6	55.7	47.1
Organizational Control	45.3	49.1	49.7	48.5
OSHA	12.3	20.5	31.9	23.2
Pensions	31.1	48.4	63.8	50.7
Personnel	57.5	65.2	75.7	67.7
Product Liability	5.7	5.6	17.8	10.6
Purchasing	80.2	90.1	89.2	87.4
Quality Control	21.7	26.1	44.3	32.5
Receipts and Disbursements	85.8	91.9	94.6	91.6
Research and Development	5.7	16.1	35.7	21.7
Revenue Sharing	2.8	9.3	16.2	10.6
SEC Reports	12.3	16.1	18.4	16.2
Tax Returns	19.8	23.6	21.1	21.7
Traffic	25.5%	29.8%	42.2%	33.8%
Sample Size	106	161	185	452

Office-Supreme Court, U.S.
FILED
OCT 18 1983
ALEXANDER L. STEVAS,
CLERK

No. 83-65

In the Supreme Court of the United States

OCTOBER TERM, 1983

LEASEWAY TRANSPORTATION CORP., ET AL.,
PETITIONERS

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether internal audit reports, prepared by a corporation's employees in the ordinary course of business, "may be relevant" within the meaning of 26 U.S.C. 7602(1) to an Internal Revenue Service audit of the corporation and therefore are subject to production pursuant to an IRS summons.

2. Whether a corporation's internal audit reports are privileged from production pursuant to an IRS summons issued under 26 U.S.C. 7602.

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In the Supreme Court of the United States

OCTOBER TERM, 1983

No. 83-65

LEASEWAY TRANSPORTATION CORP., ET AL.,
PETITIONERS

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A12) is unreported. The opinion of the district court (Pet. App. B1-B21) is reported at 523 F. Supp. 1333.

JURISDICTION

The judgment of the court of appeals was entered on April 19, 1983. A petition for rehearing was denied on June 7, 1983 (Pet. App. C1). The petition for a writ of certiorari was filed on July 15, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In July 1979, the Internal Revenue Service began a tax audit of petitioner Leaseway's corporate income tax returns for the years 1975 through 1978. Petitioner Rehor was then Leaseway's vice president in charge of tax matters. Internal

Revenue Agent Simeo was the case manager for the audit. Pet. App. B2, B4; A. 5-8, 20-23, 33-34, 38, 49, 50, 55, 81, 279, 280, 283, 291.[1]

IRS procedural manuals provide that in conducting audits such as this one, revenue agents are to examine internal audit reports ("IARs") of the taxpayer. In addition, Internal Revenue Agent Kast, the case manager for the prior audit of Leaseway, had recommended in his post-audit memorandum that Leaseway's IARs be examined in the next audit. In planning the 1975-1978 tax audit, Simeo decided to examine Leaseway's internal audit reports because of the provisions of the procedural manuals and Kast's recommendation. Pet. App. B3; A. 11-15, 28, 43, 187, 190-193, 200, 203, 255, 280.

On April 8, 1980, Rehor was served with an Internal Revenue summons requiring production of 82 audit reports pertaining to certain subsidiaries of Leaseway for various years during the audit period. On April 21, 1980, Rehor informed the audit team that Leaseway would not comply with the summons. Pet. App. B7; A. 20-27, 42, 90-94, 122-123, 129-130, 222-223, 263-264, 272-273, 282, 285-288, 291-292.

On July 1, 1980, the government initiated this action to enforce the summons in the United States District Court for the Northern District of Ohio. In his affidavit in support of the petition for enforcement, Simeo averred that the summoned reports were not in the government's possession, that the administrative steps required for issuance of the summons had been taken, and that it was necessary to examine the reports in order to complete the audit properly.

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[1] "A." refers to the appendix filed in the court of appeals.

Leaseway opposed enforcement on the ground that examination of the reports would provide no significant assistance in determining its correct tax liabilities. A. 91-94, 122-123, 263-264, 272-273, 285-288, 291-292.

In a show cause hearing conducted by the district court, Simeo stated that the IRS had not seen Leaseway's IARs and had no specific information as to their contents. Kast testified that, based on the experience of the IRS, a taxpayer's internal audit reports can provide information that is of assistance in conducting an audit and can increase the efficiency of an IRS audit by indicating particular matters that do or do not need to be investigated closely. Rehor explained that Leaseway's IARs had not been used in the preparation of its tax returns. In addition, Walter G. Kell, an accounting professor, appeared on behalf of Leaseway. He testified that he had inspected the summoned IARs at Leaseway's request and concluded that there was only a remote possibility that information in the reports would be helpful in assessing the accuracy of Leaseway's tax returns. Kell noted, however, that one of the reports concerned the plant and equipment account; that another report recommended improvements in maintaining records on accounts receivable; and that the IARs included recommendations for correcting entries in Leaseway's accounting records. Kell also acknowledged that internal audit reports can be helpful in identifying problem areas in a corporation's accounting system that would call for closer examination. Pet. App. B12; A. 30, 45-46, 88, 89, 136-137, 142, 149-154, 161-172, 175-176, 197, 199, 201, 288-289.

2. The district court enforced the summons (Pet. App. B1-B21). The court found that the Internal Revenue Code afforded broad authority to summon records bearing on a taxpayer's finances and that the "concrete facts in this case" demonstrated the relevance of the reports sought by the IRS. In particular, the court noted the Kell testimony "that

the reports contained 'reference to individual transactions' " and also "contained 'one or two correcting entries relative to an incorrect reversal of an entry or incorrect recording of an entry' * * * [that] 'could conceivably have an impact on the financial statement' from which the tax return was prepared" (*id.* at B18). The court also referred to the Kell testimony that the reports "contained 'timing adjustments' * * * that * * * could have an effect on the accuracy of a particular tax return" (*id.* at B19). Finally, the court observed that the recommendation in the reports that more detailed records be maintained to substantiate ledger entries, as summarized in the Kell testimony, was relevant because the sufficiency of the records could bear on the correctness of the tax return (*ibid.*). Based on this record, the court concluded that the internal audit reports summoned by the IRS were relevant and subject to production because they "may, in fact, shed light on the correctness of the Leaseway tax returns" (*id.* at B20).

3. The court of appeals affirmed (Pet. App. A1-A12). Stating that the "standard of relevance is whether the information sought 'might throw light upon' the inquiry" (*id.* at A7; citation omitted) and that the "showing [of relevance] must be one of a realistic expectation, rather than an idle hope, that something pertinent to the investigation may be discovered" (*id.* at A7-A8), the court of appeals agreed with the determination of the district court that "there exists a realistic expectation that something discovered in the IARs might throw light upon this investigation into the accuracy of Leaseway's tax returns" (*id.* at A8). In addition, the court of appeals rejected Leaseway's contention that the reports were privileged from production under *United States* v. *Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), cert. granted, No. 82-687 (Feb. 22, 1983). The court found it unnecessary to "pass upon the correctness of" the *Arthur Young* holding because the two cases are

"factually distinguishable" in light of the nature of the papers involved and the fact that this case — unlike *Arthur Young* — does not involve questions as to the role of independent auditors under the federal securities laws (Pet. App. A10-A11). The court also pointed out that the Second Circuit had indicated that it would enforce an IRS summons for audit reports notwithstanding that *Arthur Young* fashioned a privilege for tax accrual workpapers (Pet. App. A10-A11), and thus "even in a jurisdiction which recognizes a judicially created accountant's work-product privilege, *internal audit reports* were not considered privileged documents" (*id.* at A12; emphasis in original).

ARGUMENT

1. Petitioners contend (Pet. 17-20, 25-30) that the standard of relevance applied by the court of appeals was erroneous. However, the decision below is correct and does not conflict with any decision of this Court or of the other courts of appeals. Accordingly, further review is not warranted.[2]

Section 7602(1) and (2) of the Internal Revenue Code (26 U.S.C.) provides that the IRS is authorized to summon and examine "any books, papers, records, or other data *which may be relevant* or material to [its] inquiry" (emphasis added). See also *United States* v. *Powell*, 379 U.S. 48, 57 (1964). As Judge Friendly explained in *United States* v. *Noall*, 587 F.2d 123, 125 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979), "Congress acted advisedly in using the verb 'may be' rather than 'is,' since the Commissioner cannot be certain that the documents are relevant or material until he sees them."

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[2]Petitioners acknowledge (Pet. 20) that only four previous cases have dealt with the relevance of internal audit reports. Many of the cases on which petitioners rely (Pet. 18-20) did not pertain to IARs.

Consistent with the language and policy of Section 7602, the courts have recognized the broad authority of the IRS to obtain materials in connection with its audit of a taxpayer. In particular, the courts of appeals have consistently held that summoned materials are relevant if they might throw light upon the inquiry being made by the IRS. See, *e.g., United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994, 996 (10th Cir. 1982); *United States* v. *Will*, 671 F.2d 963, 966 (6th Cir. 1982); *United States* v. *Kis*, 658 F.2d 526 (7th Cir. 1981), cert. denied *sub nom. Salkin* v. *United States*, 455 U.S. 1018 (1982); *United States* v. *Wyatt*, 637 F.2d 293, 300 (5th Cir. 1981); *United States* v. *Richards*, 631 F.2d 341, 345 (4th Cir. 1980); *United States* v. *Freedom Church*, 613 F.2d 316, 321 (1st Cir. 1979); *United States* v. *Garden State National Bank*, 607 F.2d 61, 68-70 (3d Cir. 1979); *United States* v. *Noall*, 587 F.2d at 125-126; *United States* v. *Ryan*, 455 F.2d 728, 733 (9th Cir. 1971). The court below correctly recognized this to be the applicable standard (Pet. App. A7).

To be sure, as petitioners note (Pet. 18), some courts have added that there must be a realistic expectation, and not simply an idle hope, that the summoned information will assist in determining the taxpayer's correct tax liabilities. See, *e.g., United States* v. *City National Bank & Trust Co.*, 642 F.2d 388, 389-390 (10th Cir. 1981); *United States* v. *Wyatt*, 637 F.2d at 301; *United States* v. *Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *United States* v. *Egenberg*, 443 F.2d 512, 515 (3d Cir. 1971); *United States* v. *Harrington*, 388 F.2d 520, 524 (2d Cir. 1968). We doubt that this addition represents a substantive variation in the standard of relevance, but instead is a common-sense explication of an implicit element of the relevancy test. And, as shown by the above cases, the "might throw light upon" and the "realistic expectation" formulations, rather than being inconsistent

tests as petitioners contend, are routinely applied together and treated as a single standard.[3]

In any event, this is not an appropriate case in which to consider petitioners' assertion that the two formulations constitute conflicting standards of relevance. The court of appeals, after referring to the "might throw light upon" formulation (Pet. App. A7), immediately added that the requisite "showing must be one of a realistic expectation, rather than an idle hope, that something pertinent to the investigation may be discovered" (*id.* at A7-A8).[4] Thus, the

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[3]There is no conflict, as petitioners assert (Pet. 18-20), between *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111 (N.D.Ill. Oct. 23, 1978), and *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979). In *First Chicago Corp.*, the district court, relying on decisions of the Second and Seventh Circuits, held that certain internal audit reports were relevant and that others were not. The holding of the district court and the decisions cited by the court, as well as subsequent decisions of the Seventh Circuit (see, *e.g.*, *United States* v. *Kis*, 658 F.2d at 537), are fully consistent with *Noall* and with the standard of relevance applied in the other circuits. And in any event, a conflict between decisions of a district court and a court of appeals does not call for review by this Court. See Stern & Gressman, *Supreme Court Practice* § 4.8 (5th ed. 1978).

We note that the Court is holding the cross-petition filed by Arthur Young, No. 82-837 (filed Nov. 11, 1982), in response to the government's petition in No. 82-687. The Arthur Young cross-petition argues (Pet. 8, 9), in opposing production of audit workpapers, that "a request for documents based on their generic characteristics cannot establish relevancy without a further definition of the subject matter sought. * * * [A] summons which requests, for example, all correspondence without more cannot on its face be tested for relevancy and is *per se* improper." Given the differences between this case and No. 82-837 with respect to the questions presented, the documents at issue, and the specifications of the summonses, we do not believe that the pendency of the Arthur Young cross-petition requires that the Court also hold the instant petition.

[4]Indeed, the court of appeals cited (Pet. App. A8) many of the same cases that petitioners rely upon (Pet. 18) in their challenge to the decision below.

court of appeals in fact applied the "reasonable expectation" standard that petitioners urge, and any differences that might exist between the two formulations would not affect the outcome in this case.

Moreover, as both the district court and the court of appeals concluded, the record in this case demonstrates the relevance of the summoned reports. Agent Simeo, in his affidavit submitted in support of the petition for enforcement, stated that the proper conduct of the investigation required examination of Leaseway's IARs. In addition, the government presented testimony that IRS manuals provide for examination of IARs, that past experience indicates that IARs can further investigations, and that the IRS agent conducting the prior audit of Leaseway's returns had recommended examination of the IARs in the next audit. Cf. *United States* v. *Noall*, 587 F.2d at 126; *United States* v. *I.C. Industries, Inc.*, 83-1 U.S. Tax Cas. (CCH) para. 9149 (N.D. Ill. Jan. 12, 1983). The government thus established a prima facie case that the reports were relevant to the tax investigation.[5]

The Kell testimony offered by Leaseway to rebut the government's prima facie case further established the relevance of the IARs, as the district court specifically found (Pet. App. B18-B19). Kell stated that one of the reports involved Leaseway's account for plant and equipment, which is a matter of concern to the IRS in evaluating depreciation deductions. Kell also testified that another report indicated weaknesses in the recordkeeping for accounts receivable, which can bear on the reportable income and bad debts of the taxpayer. In addition, Kell

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[5]Petitioners acknowledge (Pet. 6 n.4; citation omitted) that internal audit reports can " 'test reporting systems in * * * financial [areas],' " and they conceded in the court of appeals (Reply Brief 3) that Leaseway's IARs involve "financial as distinguished from operational matters."

noted that other reports recommended that corrective entries be made in accounting records, which raises questions about the correctness of Leaseway's tax returns as prepared from its accounting records. And, finally, Kell acknowledged that auditors, including the IRS, can find examination of IARs to be helpful and can indicate problem areas in a company's accounting records that should be closely examined. Thus, although Kell was of the opinion that there was only a remote possibility that the IARs would be of assistance to the IRS in determining Leaseway's tax liabilities, the district court did not err in relying on other portions of his testimony in concluding that the summoned reports were not outside the bounds of relevance.[6]

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[6]We also note that in the case most heavily relied upon by petitioners (Pet. 18-19), the district court found that various internal audit reports of the taxpayer were relevant and subject to production. See *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111 (N.D.Ill. Oct. 23, 1978). See also *United States* v. *Noall*, 587 F.2d at 126, which was quoted by the court of appeals below (Pet. App. A6-A7).

Petitioners complain (Pet. 25-27, 29) that the IRS did not know what was in the IARs and therefore had no reasonable expectation of relevance. But this largely reflected the fact that Leaseway had declined to provide either the reports or a description of their contents. That the IRS had no specific information about the substance of these particular documents does not bar it from gaining access as part of an audit, and, as discussed above, the government made an adequate showing of relevance in this case. Nor, contrary to petitioners' suggestion (Pet. 27, 29), is the IRS or a district court required to take the taxpayer's word that designated materials are not relevant. While a district court may conduct an *in camera* examination of summoned documents (see *United States* v. *First Chicago Corp., supra*), it is not, as petitioners contend (Pet. 23), required to follow such a burdensome and time-consuming procedure. See *United States* v. *Noall*, 587 F.2d at 127.

The fact that the internal audit reports may not have been used in preparing Leaseway's tax returns does not render them irrelevant to the IRS's audit. Materials not used in a tax return unquestionably "may be relevant * * * [to the Commissioner's] inquiry" under Section 7602(1), and courts have enforced summonses for such materials. See, *e.g.*, *United States* v. *Euge*, 444 U.S. 707 (1980) (exemplar of the taxpayer's

2. Petitioners also argue (Pet. 8-16, 28-30) that the internal audit reports are privileged from production to the IRS under the rationale of *United States* v. *Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), cert. granted, No. 82-687 (Feb. 22, 1983). They contend that these reports serve the

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handwriting); *Donaldson* v. *United States*, 400 U.S. 517 (1971) (employment applications and background data); *United States* v. *New York Telephone Co.*, 644 F.2d 953 (2d Cir. 1981) (telephone company billing records); *United States* v. *Wyatt*, 637 F.2d 293, 300 (5th Cir. 1981) (evidence relating to illegal payments whether or not deducted on the returns); *United States* v. *Noall*, 587 F.2d at 125 (internal audit data not used in preparation of returns); *United States* v. *Cleveland Trust Co.*, 474 F.2d 1234 (6th Cir.), cert. denied, 414 U.S. 866 (1973) (net worth statements submitted to bank with loan application); *United States* v. *McKay*, 372 F.2d 174 (5th Cir. 1967) (appraisal reports); *United States* v. *Khalouf*, 49 A.F.T.R. 2d para. 82425 (N.D. Ind. Dec. 9, 1981) (video tapes); see also *United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994 (10th Cir. 1982); *United States* v. *Norcutt*, 680 F.2d 54 (8th Cir. 1982); *United States* v. *Noall*, 587 F.2d at 127; *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111, at 86035-86036.

Finally, enforcement is not barred, as amicus Pickands Mather & Co. argues (Br. 7-8), on the ground that the information contained in the internal audit reports may be found in or derived from other documents available to the IRS. Documents are not immune from production simply because they collect, summarize, or analyze information that may be uncovered in a less convenient or intelligible form elsewhere. As the court of appeals explained (Pet. App. A9):

> The IRS need not duplicate the efforts of Leaseway. To hold otherwise would be to invite taxpayers to surrender to the IRS only the minimum amount of underlying documentation available and to require the IRS to then compile the data into us[e]able form, even though such compilations already exist. Such a limited discovery rule would retard the policy interest of effective tax law enforcement and revenue collection.

See also *United States* v. *Silvestain*, 668 F.2d 1161, 1163 (10th Cir. 1982); *United States* v. *Daffin*, 653 F.2d 121, 124 (4th Cir. 1981); *United States* v. *Davis*, 636 F.2d 1028, 1037-1038 (5th Cir.), cert. denied, 454 U.S. 862 (1981); *United States* v. *Davey*, 543 F.2d 996, 1000 (2d Cir. 1976). *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111, at 86035-86036. As the Second Circuit has observed, petitioners' argument "borders on the frivolous" (*United States* v. *Noall*, 587 F.2d at 125 n.2).

important purposes of encouraging compliance with legal requirements and enhancing corporate efficiency and that the use of such reports would be deterred if they were subject to compelled production to the IRS. On this basis petitioners claim that the reports should be protected by a qualified accountant's privilege.

As demonstrated in our brief in *Arthur Young*,[7] the creation of an accountant's privilege is not warranted. This Court and the lower federal courts have, with the exception of *Arthur Young*, consistently held that there is no federally recognized accountant's privilege (U.S. Br. 35-39). These decisions reflect the fact that only the weightiest reasons of public policy can justify a privilege, which limits the availability of probative evidence and impairs the search for truth (U.S. Br. 15). And the considerations militating against the recognition of a privilege assume special force in connection with an IRS summons. "With respect to enforcement of the tax laws, Congress itself has decided the policy issue [in favor of IRS access], and it is not for the courts to challenge that determination. In this, as in many other procedural questions, the collection of the revenue stands apart." *United States* v. *Noall*, 587 F.2d at 126, quoted in U.S. Br. 44. Thus, for the reasons set forth in our brief in *Arthur Young*, we submit that petitioners' effort to establish an accountant's privilege in this case must be rejected.

We further submit that it is unnecessary for the Court to hold this petition pending its decision in *Arthur Young*. An affirmance of the Second Circuit's ruling in *Arthur Young* would not aid petitioners in this case or indicate the need for review of their contentions by this Court.

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[7] A copy of our brief is being sent to counsel for petitioners.

Fundamental differences exist between the sorts of documents at issue in the two cases. In *Arthur Young*, the tax accrual workpapers in question apparently contain, among other things, the accountant's and the taxpayer's assessment of the strengths and weaknesses of the taxpayer's position on matters that might be contested by the IRS and an indication of the taxpayer's views concerning litigation and settlement in the event of a challenge. Moreover, tax accrual workpapers are prepared as part of the audit by independent certified public accountants that is required under the federal securities laws, and thus they involve a reasonably definite and circumscribed class of material. In contrast, IARs prepared by in-house auditors are not alleged to contain information of a similarly sensitive and deliberative nature. Furthermore, by petitioners' own description (Pet. 6 & n.4, 8-11; Pet. App. D2), internal audit reports are voluntarily prepared by companies on a virtually unlimited range of subjects, including "compliance with company policy" (Pet. 6) and " 'how efficiently and economically management utilizes its resources and how effectively it achieves its objectives' " (Pet. 11; citation omitted). Under such a broad and self-defining rubric, a taxpayer would be free to label a host of documents as "internal audit reports," and the consequent restriction on IRS access and the potential for abuse by taxpayers strongly counsel against recognition of such a privilege. See *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111, at 86036.

Further, the essential basis for the *Arthur Young* decision is absent here. In *Arthur Young*, the court of appeals concluded that the federal securities laws, pursuant to which the tax accrual workpapers had been generated, represented a " 'contrary legislative purpose[]' " (677 F.2d at 219; citation omitted) that "conflict[ed]" (*ibid.*) with the policies of the Internal Revenue Code. In reconciling this perceived

"clash" (*id.* at 220) of congressional enactments and statutory policies, the court of appeals chose to give priority to the purposes of the securities law by creating a qualified privilege for tax accrual workpapers. By contrast, petitioners have pointed to no conflicting statute or countervailing legislative policy that would, in accordance with the analysis in *Arthur Young*, support the privilege they seek to establish.[8]

In line with these critical distinctions between this case and *Arthur Young*, the Second Circuit itself has rejected the very privilege that petitioners claim. In *United States* v. *Noall, supra*, which was reaffirmed in *Arthur Young*, the court of appeals held that "public policy" in favor of "full and frank disclosure to the internal auditors" does not render internal audit reports privileged from production in response to an IRS subpoena (587 F.2d at 126). See also *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111, at 86036 ("particular policy considerations" in favor of "total candor" do not give rise to a privilege for internal audit reports). Furthermore, in *Arthur Young*, the court enforced an IRS summons for audit workpapers (677 F.2d at 216) even though such "workpapers contain material learned during confidential discussions between [the taxpayer] and [the accountant]" (*id.* at 215). Thus, as the court below correctly noted (Pet. App. A12; emphasis in original), even in the Second Circuit, "which recognizes a judicially created accountant's work-product privilege, *internal audit reports* [are] not considered privileged documents."

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[8]Nor would the limited societal interest served by any resulting "enhancement of corporate efficiency" (Pet. 10) or encouragement of inquiry by auditors into a corporation's compliance with the law (Pet. 8) warrant judicial creation of an accountant's privilege from congressionally authorized investigations with respect to internal audit reports. Compare *Hickman* v. *Taylor*, 329 U.S. 495, 510-511 (1947); *United States* v. *Nobles*, 422 U.S. 225, 236-237 (1975); *Upjohn* v. *United States*, 449 U.S. 383, 389 (1981).

In the end, petitioners have failed to justify why internal audit reports — in contrast to countless other corporate documents that touch upon legal and operational issues and are unquestionably subject to compulsory production — should be privileged from an IRS summons in connection with an audit of the corporation. Petitioners understandably would prefer to withhold these reports from the IRS, but they have not offered the "weighty and legitimate competing interests" (*United States* v. *Nixon*, 418 U.S. 683, 709 (1974)) necessary to offset the manifest public need for the efficient and effective enforcement of the Internal Revenue Code. Since petitioners' claim of privilege would not be assisted by an affirmance of the Second Circuit's decision in *Arthur Young*, it is unnecessary for the Court to hold this petition pending disposition of the *Arthur Young* case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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REPLY BRIEF OF PETITIONERS, LEASEWAY TRANSPORTATION CORP. and RAYMOND J. REHOR, IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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Petitioners Leaseway Transportation Corp. ("Leaseway") and Raymond J. Rehor submit this reply brief in support of their petition for a writ of certiorari.

The argument that compelling reasons of public policy require that protection against random disclosure be accorded to Leaseway's internal audit reports ("IARs"), stands essentially unrefuted.

In its brief in opposition to the petition for writ of certiorari, the government did not challenge such reasons of public policy but chose to relegate a discussion of them to the end of its brief. In the petition for writ of certiorari, the petitioners explained why compelling reasons of public policy require protection of IARs. Pet. at 8-14. 1/ Rather than address the

1/ These reasons were again emphasized in the four amicus curiae briefs filed in support of the petition for writ of certiorari. See amicus curiae briefs of: Standard Oil Company at 12-16; Kroger Co. at 18-19; Pickands Mather & Co. at 4-6; White Consolidated at 2-3. Indeed, the interest and support expressed in the amicus curiae briefs underscore the fact that the issue presented in this case is an extremely significant issue of national importance, which should be decided by the Court at this time.

merits of these compelling reasons of public policy, the government limited its response to two conclusionary comments to support its general denial that public policy reasons require protection of IARs. 2/

2/ The government stated:

> Nor would the limited societal interest served by any resulting "enhancement of corporate efficiency" (Pet. 10) or encouragement of inquiry by auditors into a corporation's compliance with the law (Pet. 8) warrant judicial creation of an accountant's privilege from congressionally authorized investigations with respect to internal audit reports.

Br. In Opp. at 13, n. 9. The government also stated that petitioners:

> [H]ave not offered the "weighty and legitimate competing interests" (United States v. Nixon, 418 U.S. 683, 709 (1974)) necessary to offset the manifest public need for the efficient and effective enforcement of the Internal Revenue Code.

Br. In Opp. at 14. For our response to the government's unwarranted assertion that petitioners would have this Court create an "accountant's privilege" for IARs, see pages 5 & 6, below.

Nowhere did the government provide a reason of public policy to support why the Internal Revenue Service ("IRS") should be entitled to summon IARs without apparent limits.

If this Court does not grant the petition, then the IRS's newly adopted policy of obtaining IARs during the course of a routine tax audit will be preserved 3/ and the undisputed public benefits derived from the use of IARs will be lost. See Pet. at 12-14. 4/

3/ Nowhere did the government deny that IRS has adopted such a new policy, which will remain intact if this Court denies the petition. See Internal Revenue Manuel (Audit) (CCH) Case Managers Handbook Ch. 600 § 610 (1980).

4/ This Court has emphasized that it has upheld the IRS "summons authority ... absent express statutory prohibition or substantial countervailing policies." United States v. Euge, 444 U.S. 707, 711 (1980). (Emphasis supplied.) Petitioners have clearly shown such substantial countervailing policies.

Furthermore, the petitioners' argument in regard to the relief requested should this Court grant the petition and decide in favor of the petitioners has been distorted. First, the government stated that "petitioners claim that the reports should be protected by a qualified accountant's privilege" and proceeded to explain why such a privilege is unfounded. Br. In Opp. at 11. The petitioners never stated that the IARs should be protected by a qualified accountant's privilege. 5/ Indeed, petitioners consciously refrained from taking any such position, because this Court can grant the petition and rule on the case without extending any qualified accountant's privilege

5/ Such an egregious misstatement not only fails to respond to the petitioner's policy argument, but casts an aspersion on the credibility of the government's analysis.

to cover IARs. 6/ To suggest that petitioners claim a qualified accountant's privilege serves only to obscure the policy issue, which the government chose to do rather than respond to it directly.

Second, it is stated that "petitioners contend" that the district courts be "required" to have in camera inspections of the summoned documents. Br. In Opp. at 9, n. 5. Again, the petitioners never stated that this Court should "require" district courts to have in camera inspections. Petitioners instead stated that the trial court "should be required to balance" the IRS's need for the documents against the taxpayer's need for

6/ Petitioners merely request that the Court grant the petition and rule that in order for the IRS to obtain IARs it must have a reasonable expectation that the IARs are relevant to the tax audit balanced against the need for confidentiality of IARs. See Pet. at 28-30. In so doing the Court need not address the qualified accountant's privilege.

confidentiality. This balance could be struck on the basis of questions by the trial judge (or counsel) directed to determining the general subjects covered by the IARs and the extent of the need of the IRS and the likely relevance of the IARs. Moreover, it "may readily be struck" by in camera procedures. Pet. at 22, 24. Petitioners' assertion stands that in camera review of Leaseway's IARs is an easy practical solution to the dispute in this case.

For the foregoing reasons, as well as for the reasons stated in the petition, the Petition for a Writ of Certiorari to the

United States Court of Appeals for the Sixth Circuit should be granted.

Respectfully submitted,

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October 28, 1983

No. 83-65

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In The

SUPREME COURT OF THE UNITED STATES

October Term, 1983

Leaseway Transportation Corp. and
Raymond J. Rehor,

Petitioners,

v.

United States of America and
James Simeo,

Respondents.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the Sixth Circuit

BRIEF OF THE KROGER CO. AS AMICUS CURIAE IN SUPPORT OF AFFIRMANCE

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QUESTION PRESENTED FOR REVIEW

In a proceeding brought by the Internal Revenue Service to enforce a summons for a corporate taxpayer's internal audit reports, should the courts take into account public policies favoring the confidentiality of such reports?

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In The

SUPREME COURT OF THE UNITED STATES

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No. 83-65

Leaseway Transportation Corp. and
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On Petition for Writ of Certiorari
to the United States Court of Appeals
for the Sixth Circuit

BRIEF OF THE KROGER CO. AS AMICUS CURIAE

INTEREST OF AMICUS CURIAE

The Kroger Co. is a large, publicly held food processing and retailing corporation with its headquarters in Cincinnati, Ohio. Like Petitioner Leaseway Transportation Corp. ("Leaseway"), The Kroger Co. is classified as a "large case" by the Internal Revenue Service (the "Service"), and as such is subject to continual audit by the Service with respect to its federal income tax returns. In the course of these audits, the Service makes numerous requests for the production of documents.

Like most large corporations, The Kroger Co. prepares internal audit reports that are similar in nature to those at issue here. Such reports

are not used in connection with the preparation of tax returns, but are prepared solely for non-tax purposes.

The interest of The Kroger Co. as amicus curiae is to support the petition for writ of certiorari because of the substantial need for guidance and clarification on the scope of the Service's summons power with respect to documents such as internal audit reports. This issue affects The Kroger Co. and all other corporate taxpayers that prepare internal audit reports.

SUMMARY OF ARGUMENT

In recent years, a number of cases have examined the enforceability of summonses issued by the Service directed at documents that are not

prepared in connection with tax returns and contain no primary factual information that is not already available to the Service from the taxpayer's books and records. Such documents include tax pool analyses, proposed budgets, and internal audit reports. These cases are similar in that the Service seeks access to the documents not for the purpose of obtaining factual information, which could be obtained elsewhere, but purely for convenience in the conduct of audits. There are often substantial reasons of public policy for preserving the confidentiality of these documents.

There is a split of authority among the courts as to the proper approach in cases of this type. Some

courts routinely have granted enforcement of the summonses based on a mere possibility that the documents may contain information relating to tax liability, without requiring any showing of particularized need or a reasonable expectation that the documents contain relevant information. Other courts have balanced the Service's need for the documents against the competing policy considerations, and have denied enforcement in appropriate cases. One such case, United States v. Arthur Young (No. 82-687), is now before this Court.

We believe that these cases, including the Leaseway case on internal audit reports, raise fundamental questions about the scope of the Service's summons power and the

appropriate function of the courts in summons enforcement cases. These questions require definitive resolution. The issues will continue to arise in the future with great frequency, since the Internal Revenue Manual used by auditing agents directs the agents to request these documents in many cases.

Amicus believes that where documents of this type are summoned by the Service, courts must consider public policy in deciding whether to grant enforcement. Where public policy considerations in favor of confidentiality are strong, the courts should refuse to enforce the summons, or at least require a more particularized showing of need or an expectation of relevance beyond

that required for the more usual sources of primary factual information.

ARGUMENT

I. THE CONFLICT OF AUTHORITY OVER THE STANDARDS TO BE USED IN DETERMINING THE SCOPE OF THE SERVICE'S SUMMONS POWER OVER DOCUMENTS SUCH AS INTERNAL AUDIT REPORTS MUST BE RESOLVED

Section 7602 of the Internal Revenue Code[1] grants the Service the authority to issue summonses in pursuance of its duties to investigate tax liability and collect taxes. Section 7604 provides a mechanism by which the Service may obtain court enforcement of such summonses in appropriate cases.

---

[1] All references to sections, unless otherwise specified, are to the Internal Revenue Code of 1954, as amended, 26 U.S.C. §§ 1 et seq.

It is clear that, before a court will enforce a summons issued by the Service, four threshold showings must be made. It must be shown that the investigation is being conducted pursuant to a legitimate purpose, that the material sought may be relevant to that purpose, that the information is not already in the Service's possession, and that the proper administrative steps have been followed. United States v. Powell, 379 U.S. 48, 57-58 (1964). As discussed below, additional policy factors may also enter into the decision whether to enforce the summons.

The courts have found these standards difficult to apply in cases where the summoned documents are not used in connection with the preparation

of a tax return and contain no data that are not available elsewhere. Some courts have found that the attenuated possible relevance of these documents was outweighed by the need to protect taxpayers from overbroad investigation or by public policies favoring the preservation of the confidentiality of such documents. In United States v. Matras, 487 F.2d 1271 (8th Cir. 1973), for example, the court denied enforcement of a summons for proposed budgets that the Service wished to use as a "road map" in conducting its audit. The court noted that "the government should not, for the mere sake of its convenience, impose unnecessary burdens on a taxpayer in conducting an audit or investigation for tax liability." 487 F.2d at 1275. In United States v.

Coopers & Lybrand, 550 F.2d 615 (10th Cir. 1977), the Service sought a tax pool analysis that contained an estimate of a corporate taxpayer's contingent tax liability. The court denied enforcement, stressing that the document was not used in the preparation of any tax return and that "[m]ere convenience does not make an item producible under an IRS summons." 550 F.2d at 621. In United States v. Arthur Young & Co., 677 F.2d 211 (2d Cir. 1982), cert. granted, 51 U.S.L.W. 3611 (U.S., Feb. 22, 1983) (No. 82-687), the court refused to enforce a summons for a tax pool analysis on the ground that the Service's need for the information was outweighed by the public policy in favor of preserving the confidentiality of communications between corporations and their independent auditors.

Other courts, however, have focused on the literal language of section 7602 that the summons power extends to any material that "may be relevant" to the Service's investigation, and have declined to accord much weight to any competing considerations. In United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3400 (U.S., Nov. 23, 1982) (No. 82-716), the court ordered enforcement of a summons for a tax pool analysis, stating that "[w]e are not swayed by the argument that the public policy of the securities laws implicitly overrides the clear grant of summons power to the IRS." 682 F.2d at 544. In United States v. Noall, 587 F.2d 123 (2d Cir. 1978),

the court enforced a summons for internal audit reports, observing that "[w]e are unpersuaded by appellant's argument that enforcement of the summons runs counter to public policy." 587 F.2d at 126.

The internal audit reports at issue here were prepared by Leaseway for purposes unrelated to the filing of its tax returns, and would appear to contain no information not available elsewhere. Their main usefulness in the conduct of a tax audit will be to identify areas in which the Service may wish to concentrate its attention, rather than to supply specific items of factual information. A summons for their production raises the issues that, as discussed above, the courts have found troublesome.

The uncertainty over the proper analysis in these cases needs to be resolved. Issues of this type will continue to arise frequently, because auditing agents are instructed by the Service to request access to documents of this type. See, e.g., Internal Revenue Manual, sections 622 (internal audit reports) and 4024 (tax pool analyses).

II. THE PROPER APPROACH IS TO WEIGH THE SERVICE'S NEED FOR, AND THE DEGREE OF RELEVANCE OF, THE SUMMONED MATERIALS AGAINST THE PUBLIC POLICIES THAT FAVOR PRESERVING CONFIDENTIALITY.

Amicus believes that a balancing approach is required to resolve the problems presented by cases of this type. If enforcement of the summons would conflict with substantial public policies, the court should balance

those policies against the need for enforcement to determine which should prevail. As this Court has stated, the Service's summons authority "should be upheld absent express statutory prohibition or substantial countervailing policies." United States v. Euge, 444 U.S. 710, 711 (1980) (emphasis supplied).

This principle means that even if the four Powell factors are present, the federal courts need not enforce a summons if it is also demonstrated that enforcement would contravene important public policies that outweigh the Service's need for the information sought. In United States v. Arthur Young & Co., supra, the Second Circuit Court of Appeals denied enforcement of a summons despite the District

Court's finding that the four Powell factors had been demonstrated because "the countervailing policies at issue in the case before us require us to fashion protection for the work [of] independent auditors . . ." 677 F.2d at 219.

The balancing approach may require the court to assess the degree of relevance of the summoned material. Case law supports the proposition that a more particularized showing of reasonable expectation is appropriate where the intrusion caused by the summons is great. See, e.g., United States v. Harrington, 388 F.2d 520 (2d Cir. 1968) (summons for records held by third party enforced because showing of high degree of relevance was made); United States v. First

Chicago Corp., 79-1 U.S.T.C. ¶ 9111 (N.D. Ill. 1978) (summons enforcement denied with respect to 15 of 23 internal audit reports because relevance not established). For primary documents such as the taxpayer's books and records, there will ordinarily be little dispute that the information contained therein is highly relevant to tax liability, and there will be no reason to keep the records confidential. For more sensitive documents like tax pool analyses and internal audit reports, however, which are sought for the convenience of the Service in conducting its audit rather than for any raw data they contain, a greater showing of relevance should be required. Rather than accept conclusory assertions that such documents may be relevant to the

examination, the Service should be required to show that it has a particularized need for the specific documents sought, or that it has some concrete indication that the documents are likely to contain relevant information. Such a showing will enable the court to assess the degree to which the Service actually needs the summoned material.

Supplied with this information, the court can then make a reasoned determination whether the summons should be enforced. If the summoned material is highly relevant and there is little reason to preserve its confidentiality, an enforcement order is appropriate. If, on the other hand, the relevance of the materials is slight and substantial policies

favor confidentiality, the court should refuse to order enforcement. The balancing process is the best way in which the competing considerations can be accommodated.

III. SUBSTANTIAL PUBLIC POLICIES MILITATE AGAINST THE ROUTINE DISCLOSURE OF INTERNAL AUDIT REPORTS TO THE INTERNAL REVENUE SERVICE AND THE LOWER COURTS' FAILURE TO CONSIDER THESE POLICIES WAS ERROR

The public policies that favor preservation of the confidentiality of internal audit reports are thoroughly described in the petition for writ of certiorari filed by Leaseway Corp., and we will not reiterate them in detail here. It is clear that the public derives substantial benefit from audit reports that are the result of thorough investigation and candid cooperation; such benefits include

improved compliance with the many complex laws and regulations governing modern business operations, and improved corporate efficiency that creates a more healthy economy. It is likewise clear that these benefits would be jeopardized if the Service were granted routine access to internal audit reports, because a chilling of investigation and cooperation would be the inevitable practical result. Destroying the confidentiality essential to effective internal auditing would interfere with management's ability to monitor the corporation's compliance with the laws, and would therefore raise issues of substantial public concern.

CONCLUSION

This case raises issues of fundamental importance to the administration of the internal revenue laws. Clarification and guidance are needed in determining how conflicting interests in this area are to be resolved. For the reasons set forth above, the Court should issue a writ of certiorari in order to consider these important issues of law and public policy.

Respectfully submitted,

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APPENDIX

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Office of the Solicitor General

Washington, D.C. 20530

September 8, 1983

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Re: Leaseway Transportation Corp. v. United States, No. 83-65

Dear Mr. Fuller:

As requested in your letter of September 7, 1983, I hereby consent to the filing of a brief amicus curiae on behalf of the Kroger Company.

Sincerely,

Rex E. Lee
Solicitor General

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Re: Leaseway Transportation Corp. and Raymond J. Rehor v. United States of America, Supreme Court No. 83-65

Dear Mr. Fuller:

Counsel for Leaseway Transportation Corp. and Raymond J. Rehor hereby consent to the filing of a brief amicus curiae on behalf of The Kroger Company.

Sincerely,

Marian Pomeroy

HP:nhk
cc: The Honorable Rex E. Lee

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No. 83-65

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

LEASEWAY TRANSPORTATION CORP. and
RAYMOND J. REHOR,

Petitioners,

v.

UNITED STATES OF AMERICA and
JAMES SIMEO,

Respondents.

BRIEF *AMICUS CURIAE* OF PICKANDS MATHER & CO. IN SUPPORT OF PETITION OF LEASEWAY TRANSPORTATION CORP. and RAYMOND J. REHOR FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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IN THE
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OCTOBER TERM, 1983

No. 83-65

LEASEWAY TRANSPORTATION CORP.
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v.

UNITED STATES OF AMERICA,
and JAMES SIMEO,

Respondents.

BRIEF AMICUS CURIAE OF PICKANDS MATHER & CO. IN SUPPORT OF PETITION OF LEASEWAY TRANSPORTATION CORP. AND RAYMOND J. PEHOR FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIPCUIT

This brief in support of Petitioners' Petition for a Writ of Certiorari is submitted with the written consent of counsel for all parties, copies of which have been filed with the Clerk of the Court.

INTEREST OF THE AMICUS CURIAE

Amicus Curiae Pickands Mather & Co. ("PM") is a Delaware corporation engaged in the businesses of iron ore and coal mining and bulk transportation. Its federal income tax return is filed as part of a consolidated return with its parent corporation, Moore McCormack Resources, Inc. ("MMR"), which is also a Delaware corporation, and whose shares are publicly held.

PM has a full-time Internal Audit Department that regularly and routinely performs the kinds of work listed in footnote 4 of the Petition for a Writ of Certiorari of Leaseway Transportation Corp. ("Leaseway"). Reports to management are prepared by personnel of that department who review its work, summarize its findings and list recommendations for action, where appropriate. Accordingly, PM has an interest in the outcome of this litigation.

SUMMARY OF ARGUMENT

1. Confidentiality of Internal Audit Reports ("IARs") is critical to the effective performance of the internal audit function and hence to compliance with the law by business.

2. The source data reviewed by internal auditors in the performance of their work is readily available to the Internal Revenue Service ("IRS") which under its regular audit procedures has full access to a taxpayer's employees and records to carry out its audit. Accordingly, the IRS has no need for access to the internal auditors' workpapers or thought processes through the examination of IARs.

3. The IRS should be held to a reasonable standard of relevance in order to obtain IARs in the course of an audit. The IRS should show a realistic expectation that the IARs are relevant to the audit before the IARs are made available to it.

ARGUMENT

I. CONFIDENTIALITY IS ESSENTIAL TO CONTINUED VITALITY OF INTERNAL AUDIT REPORT PROCEDURE.

As pointed out by Leaseway in its Petition for a Writ of Certiorari (p.6, footnote 4), internal auditors concern themselves with the "policies, operational approaches, utilization of resources, manpower performance and results achieved," and "evaluate controls, check compliance with policies and procedures, and test reporting systems in the nonfinancial areas of corporations as well as in the financial." In the course of performing these duties on behalf of their employers, internal auditors routinely review books, records, and other source data of the employer and also interrogate and review with other corporate employees compliance with their employer's requirements addressing these significant business concerns.

In furtherance of their duties, the internal auditors make notes of interviews with

other employees for purposes of preparing reports to corporate management of their findings and recommendations. IARs are frequently informative about the quality of internal control programs and the level of compliance with such programs by corporate employees. In many instances these reports bypass management and are made directly to the employers' Boards of Directors. Thereafter these reports are utilized by management or audit committees of Boards to determine operational efficiency.

Corporate compliance with the law is enhanced when internal auditors are free to make inquiries of other employees of the corporation to whatever extent is appropriate in evaluating compliance with company policies and procedures, to record such conversations and to report candidly to management.

A critical function of that freedom is the candor with which other corporate employees will conduct these discussions. If

there is a concern that matters discussed are subject to third party disclosure full candor will inevitably be discouraged, if not shut off. Disclosure would be discouraged in the same manner that candid responses to the questionnaires developed by the general counsel for Upjohn Co. (in connection with that corporation's investigation of so-called "sensitive payments") would have been less likely if those employees did not believe their disclosures would be treated as "highly confidential." Upjohn Co. v. United States, 449 U.S. 383, 387 (1981). In its opinion in that case, this Court stated:

> Consistent with the underlying purposes of the attorney-client privilege, these communications must be protected against compelled disclosure.

449 U.S. at 395.

II. INTERNAL AUDIT REPORTS SHOULD NOT BE SUBJECT TO AN IRS SUMMONS SINCE THE INFORMATION AND DATA THEY CONTAIN ARE OTHERWISE AVAILABLE TO THE IRS.

The test for disclosure by IRS summons provided by this Court in United States v. Powell, 379 U.S. 48, 57-58 (1964) requires that before an IRS summons may be issued requesting information or data of a taxpayer, the information or data must not otherwise be available to IRS. This requirement effectively eliminates duplication of effort and expense for the taxpayer and it allows the IRS to receive information not already in its possession. As noted by the Second Circuit Court in United States v. Arthur Young & Co.:

> The corporation's own books and the audit workpapers furnish the IRS with all the raw data that it needs to calculate the taxpayer's tax liability. A roadmap would merely save the IRS some time in finding the best arguments for asserting a deficiency.

677 F.2d 211, 220 (2d Cir. 1982), cert. granted, 51 U.S.L.W. 3611 (U.S. Feb. 22, 1983) (No. 82-687).

All of the books, records, and other data used by internal auditors in the performance of their duties and all of the employees interrogated by them are readily accessible to the IRS. No claim is made that the protection of the IAPs sought by Leaseway extends to these other sources of information and data. Thus, pursuant to the third requirement of Powell, IAPs should not be within the scope of an IRS summons.

III. IF INTERNAL AUDIT REPORTS ARE TO BE SUBJECT TO AN IRS SUMMONS, THE IPS SHOULD HAVE A REALISTIC EXPECTATION THAT THE REPORTS WILL BE RELEVANT TO THE TAX AUDIT.

The test for disclosure by IRS summons in Powell also provides that the information sought must be relevant to the tax audit. 379 U.S. at 57. This Court, however, has not formulated the degree of relevance necessary to enforce a summons under this requirement. In the absence of an articulated standard from this Court, the lower courts have applied conflicting approaches to the relevance test.

Many courts have said that the summons must seek information that "might throw light upon the correctness of the taxpayer's return." E.g., United States v. Turner, 480 F.2d 272, 279 (7th Cir. 1973); United States v. Egenberg, 443 F.2d 512 (3d Cir. 1971); United States v. Wyatt, 637 F.2d 293 (5th Cir. 1981). However, many other courts have refined this standard by requiring, as a precondition to summons enforcement, that the IRS show "a realistic expectation rather than an idle hope that something may be discovered." E.g., United States v. Matras, 487 F.2d 1271, 1274 (8th Cir. 1973); United States v. Harrington, 388 F.2d 520 (2d Cir. 1968).

This Court should resolve the conflict in the lower courts and apply the more reasonable "realistic expectation" standard. The more stringent standard is especially appropriate in view of the strong public policy which supports the need for confidentiality of IARs. If this Court does not

apply the more reasonable standard, the administrative convenience of the IRS will prevail and IARs will routinely be within the IRS summons power. In such a scenario, as stated by the court in Matras:

> ...it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation and thus, according to the government, be deemed relevant to the tax investigation.

487 F.2d at 1275.

Such a broad standard of relevance would inevitably impair the effectiveness of the internal audit function of corporations, such as the Amicus Curiae. Accordingly, the benefits of encouraging operational efficiency and enhancing compliance with the law would be lost. It is thus necessary that this Court moderate the IRS summons power to restrict access to IARs to those situations where the IRS shows that it has a clear need for the information and a realistic expectation that they are relevant to the tax audit.

The well established procedure of in camera review of documents, such as IARs, by the trial court should be used to apply this standard. See, e.g., United States v. Noall, 587 F.2d 123 (2d Cir. 1978). The IARs could be reviewed in chambers by the trial judge, his clerks or a special magistrate to ensure that the IRS only obtain those IARs for which it has a need and realistic expectation of relevance.

CONCLUSION

Amicus Curiae respectfully submits that Leaseway's Petition for a Writ of Certiorari should be granted to afford this Court the opportunity to consider whether IARs are within IRS summons power. Amicus Curiae believes IRS should not have access to IARs because:

1. Confidentiality of internal audit reports is crucial to the effective performance of the internal audit function of a business, and is therefore crucial in the ordinary and regular audit procedure to encourage full compliance with the law.

2. The underlying source data and the testimony of the taxpayer's employees are available to the IRS under the Powell test.

3. Unless the IRS is held to the standard of having a realistic expectation of relevance based upon a showing of need, the benefits presently derived from the internal audit report procedure will no longer be enjoyed.

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No. 83-65

IN THE
Supreme Court of the United States
OCTOBER TERM, 1983

LEASEWAY TRANSPORTATION CORP. and
RAYMOND J. REHOR,
Petitioners,

v.

UNITED STATES OF AMERICA and
JAMES SIMEO,
Respondents.

BRIEF *AMICUS CURIAE* OF THE STANDARD OIL COMPANY IN SUPPORT OF PETITION OF LEASEWAY TRANSPORTATION CORP. AND RAYMOND J. REHOR FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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This brief in support of Petitioners' petition for a writ of certiorari is submitted with the written consent of counsel to all parties, copies of which have been filed with the Clerk of the Court.

INTEREST OF THE *AMICUS CURIAE*

The *amicus curiae* is The Standard Oil Company, an Ohio corporation which with its subsidiaries is commonly referred to as "Sohio." Like the petitioner Leaseway Transportation Corporation, Sohio is a publicly held corporation that has a well-established internal audit report procedure. Consequently, Sohio has an immediate interest in the issue presented by this case, namely the scope of the authority of

the Internal Revenue Service to obtain internal audit reports[1] in the course of an audit examination through the enforcement of a summons issued under Section 7602 of the Internal Revenue Code. In view of the present conflict of authority on the proper standard of relevance applicable to such a summons, Sohio is submitting this brief in an effort to persuade the Court to resolve, in a fashion that satisfactorily accommodates competing policy considerations, the legal issues arising out of the continued efforts of the Internal Revenue Service to seek enforcement of summonses issued to procure internal audit reports.

SUMMARY OF ARGUMENT

The *amicus curiae* respectfully submits that there are two reasons why this Court should grant Petitioners' petition for a writ of certiorari. First, this case affords the Court the opportunity to resolve the uncertainty under present law as to the circumstances under which the Internal Revenue Service ("IRS" or "Service") can obtain judicial enforcement of summonses of internal audit reports issued under Section 7602 of the Internal Revenue Code. Specifically, the courts are in conflict as to whether the applicable standard of relevance required under *United States v. Powell*, 379 U.S. 48 (1964), is one which imposes upon the IRS the burden of demonstrating the existence of a "reasonable expectation" that the documents sought will "shed light" upon the correctness of the tax return in question or is instead one under which the IRS need only show that the documents will make it more "convenient" for the IRS to discharge its responsibility of verifying the accuracy of the tax return. The Court should consider this case in order to

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[1] A detailed discussion of the nature and purpose of internal audit reports is contained at pp. 13-14 of this Brief. *See also* Petition for Writ of Certiorari at 6.

resolve this legal conflict as it relates to internal audit reports and to fashion uniform criteria that make it clear that more than administrative convenience must be established to satisfy the relevance requirement of *Powell*.

Second, this case serves as an appropriate vehicle for the Court to examine the scope of the IRS's power to procure enforcement of summonses under Section 7602 in light of the substantial countervailing policy considerations associated with the exercise of the summons power. The Court should circumscribe the IRS's ability to enforce summonses in order to achieve a satisfactory balance between the government's need for an efficient and effective administration of the federal income tax and the public's interest in protecting the corporate taxpayer's internal records from unwarranted disclosure.

ARGUMENT

I. THE COURT SHOULD CLEARLY DEFINE THE STANDARDS FOR APPLICATION OF THE RELEVANCE REQUIREMENT OF SECTION 7602 IMPOSED BY *UNITED STATES V. POWELL*.

Section 7602 vests the IRS with summons power in connection with the examination of income tax returns. That section provides, in part:

> "For the purpose of ascertaining the correctness of any return . . . the Secretary is authorized —
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon . . . any officer or employee [of the taxpayer] . . . to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data . . . as may be relevant or material to such inquiry."

The criteria for judicial enforcement of an IRS summons under Section 7602 were established by this Court in *United States v. Powell*, 379 U.S. 48 (1964). In *Powell*, the Court held that to obtain enforcement of a Section 7602 summons, the IRS must make a preliminary showing that (1) the investigation will be conducted pursuant to a legitimate purpose; (2) the inquiry will be relevant to that purpose; (3) the information sought is not already within the possession of the IRS; and (4) the administrative steps required under the Internal Revenue Code have been followed.

Although the greatest source of controversy with respect to the enforceability of IRS summonses has proved to be the second element of the *Powell* test—the requirement of relevancy—this Court has not heretofore had occasion to articulate a consistent standard for determining the degree of relevance necessary to enforce a summons issued under Section 7602. Unfortunately, in the absence of guidance from this Court, the lower federal courts have applied conflicting approaches to both the interpretation and the application of the relevance test.

The test most often utilized by the courts is that the summons must seek information that "might throw light upon the correctness of the taxpayer's return." *United States v. Turner*, 480 F.2d 272 (7th Cir. 1973); *United States v. Egenberg*, 443 F.2d 512 (3d Cir. 1971); *United States v. Wyatt*, 637 F.2d 293 (5th Cir. 1981). Most courts, however, have refined this standard by requiring, as a precondition to summons enforcement, that the government demonstrate "a realistic expectation rather than an idle hope that something may be discovered." *United States v. Matras*, 487 F.2d 1271 (8th Cir. 1973); *United States v. Harrington*, 388 F.2d 520 (2d Cir. 1968). Nevertheless, while the courts have embraced the "might shed light"/"reasonable expectation" test rather consistently, an examination of the case law in this area reveals that, in

practical application, this frequently articulated standard has received a widely varying range of interpretations, resulting in the uneven application of the relevance requirement.

One manifestation of the divergent approaches that the courts have adopted in applying the "might shed light" standard is the cases dealing with the enforceability of summonses to procure tax accrual workpapers. In *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977), the Tenth Circuit affirmed the district court's finding that tax accrual workpapers were not relevant to the purpose for which they were sought, namely the determination of income tax liability, and accordingly denied enforcement of the IRS summons that sought the production of the workpapers. As one element of its reasoning, the court recognized that documents such as these may become the target of a summons not because of any inherent relevancy to the ascertainment of tax liability but because of their value as a roadmap to the potential weaknesses in the return. In this regard, the court endorsed the view expressed by the Eighth Circuit in *Matras, supra*, in which the Service's generalized claim of relevance with respect to internal corporate documents had been denied, that "[t]he term 'relevant' connotes and encompasses more than 'convenience.' " If it did not, the Tenth Circuit, citing *Matras*, was quick to note,

> "it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation, and thus, according to the government, be deemed relevant to the tax investigation."

550 F.2d at 621.

The court in *Coopers & Lybrand* emphasized that the summons power provided by Section 7602 does not consti-

tute a license to examine a taxpayer's records where no reasonable basis for the investigation exists. Quoting *United States v. Theodore*, 479 F.2d 749 (4th Cir. 1973), the court observed:

> "A summons will be deemed unreasonable and unenforceable if it is overbroad and disproportionate to the end sought. . . . The Government cannot go on a 'fishing expedition' through appellants' records."

550 F.2d at 621.

On the other hand, in *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 51 U.S.L.W. 3611 (U.S. Feb. 22, 1983) (No. 82-687), the Second Circuit manifested a markedly different view of the relevance requirement. While acknowledging the "might shed light" test as the operative standard, that court held tax accrual workpapers similar to those considered in *Coopers & Lybrand* to be relevant to the Service's examination. In so doing, the court squarely rejected the thinking of *Coopers & Lybrand* as to the proper application of that test:

> "Appellants derive considerable support for the proposition that this material is irrelevant from the Tenth Circuit's decision in *Coopers & Lybrand*, . . . and from *United States v. Matras* . . . , where the Eighth Circuit refused to enforce a §7602 summons for taxpayer's proposed budgets. The reasoning in both cases can be summed up as follows: Tax liability depends on the taxpayer's actual transactions, not on what the taxpayer thinks and plans. Tax accrual workpapers reflect what the taxpayer—and his accountant—think about transactions that have already taken place; budgets reveal how the taxpayer hopes to conduct his affairs in the future. They are thus both irrelevant to the question of actual transactions, and therefore to the issue of liability for taxes. These courts conceded that both sorts of documents would be convenient to the IRS

> because they give the Service a 'road map' for following the management of the taxpayer's business. They went on to hold, however, that '[t]he term "relevant" connotes and encompasses more than "convenience". ' . . . Consequently, they refused to require that the documents requested be turned over to the government.
>
> We cannot agree with such a restrictive definition of relevance."

677 F.2d at 218.

In finding that the summons satisfied the "might throw light" standard, the court reasoned:

> "The documents at issue here certainly pass this low threshold of relevance. Different tax positions lead to different amounts of liability. It is difficult to say that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in his return would not throw 'light upon' the correctness of the return."

677 F.2d at 218-19. Thus, it is plain that the Second Circuit's determination of relevance was firmly rooted in its view that the papers derive their relevance from their perceived convenience to the Service. Somehow lost in the court's preoccupation with administrative convenience, however, was the familiar proposition that the IRS must establish relevance by showing a "reasonable expectation" —not merely an "idle hope"—that the targeted documents would bear directly on the correctness of the tax return.

The Fifth Circuit adopted a similar approach in *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3400 (U.S. Nov. 23, 1982) (No. 82-716), when it too held that tax accrual workpapers were relevant on the articulated ground that they might shed light on the corporation's tax liability. Like *Arthur Young*,

however, *El Paso* bespeaks an implicit rejection of the "reasonable xpectation" standard in favor of a much lower threshold, one that can be met by a mere showing that the documents are valuable by virtue of the convenience they provide the Service. This is evident from the court's statement that

> "Documents that focus and concentrate the Service's energy on questionable positions in the return . . . are highly relevant."

682 F.2d at 537.

The disparity that has emerged in the application of the relevance requirement has also revealed itself in the area of internal audit reports. In *United States v. First Chicago Corp.*, 79-1 U.S.T.C. ¶9111 (N.D. Ill. 1978), the court, applying the reasonable expectation test, concluded that many of the taxpayer's internal audit reports were not relevant. There the court wrote:

> "This Court has not found documents relevant which are exclusively discussions of internal operating procedures or of the efficiency with which procedures are being followed. Nor have we found relevant reports which are spot-checks of individual departments within respondent, but which make passing references to individual, *de minimis* transactions."

79-1 U.S.T.C. at 86,037.

A directly contrary result, however, was reached in *United States v. Noall*, 587 F.2d 123 (2d Cir. 1978), where the court enforced a summons to obtain internal audit reports on the ground that they "might throw light upon the correctness of the return." The court was led to this conclusion, however, less by its belief that such reports were likely to bear directly on the accuracy of the return than by its conviction that the reports would serve as a convenient tool to the Service in its examination of the tax return. Thus, the court observed:

> "[T]he internal audit reports and related work papers pass the applicable test. Clearly the purposes of the internal audit include the detection of overstatements or understatements of revenues or expenses, and of identifying accounting procedures that would lead to these. If the internal auditors have ascertained an understatement of revenues or an overstatement of expenses, this plainly might throw light on the correctness of the returns. We find no significance in the point, stressed by appellant, that the internal audit reports and related work papers were not used in preparing [the taxpayer's] income tax returns. The Commissioner's interest lies in whether the tax returns correctly reflected [the taxpayer's] actual income, not simply whether they were correctly prepared from the books of account and other records used."

587 F.2d at 126.

Thus, the differing solicitude that the various courts have shown for the "convenience" of the IRS has bred considerable confusion and inconsistency in the approach that the federal courts have adopted to the requirement of relevance. On the one hand, the Second and the Fifth Circuits appear to have imparted virtual talismanic significance to whether the summoned documents would enhance the administrative convenience of the IRS in the performance of its audit function. In practice, this has inevitably resulted in a much more relaxed threshold of relevance that is seemingly detached from any direct connection to the correctness of the return. In the present case, it is plain that the Sixth Circuit has aligned itself with this more relaxed approach of the Second and Fifth Circuits. In contrast, the Eighth and Tenth Circuits have explicitly found such assertions of administrative convenience an insufficient basis to support a determination of relevance. These courts have given meaningful content to the proposition that the IRS must demonstrate "a realistic ex-

pectation rather than an idle hope." In short, although the courts frequently appear to be articulating the governing standard of relevance in similar terms, in practice they have been applying it very differently. The need for guidance from this Court is thus apparent. This case, together with *Arthur Young, supra,* in which the Court has granted certiorari, and *El Paso, supra,* in which certiorari is pending, presents the Court with an appropriate opportunity to resolve these divergent approaches to the relevance requirement.

The *amicus curiae* respectfully submits that the Court should take this opportunity to give renewed content to the standard requiring a demonstration of "realistic expectation rather than an idle hope" of relevance to the taxpayer's tax return. Otherwise, it seems inescapable that, if administrative convenience becomes the touchstone of relevance, in the words of the *Matras* court,

> "it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation and thus, according to the government, be deemed relevant to the tax investigation."

487 F.2d at 1275.

In short, a standard guided by convenience is no standard at all. By its terms, it encompasses documents and records bearing the most attenuated relationship to the return. Under this test, an item derives its relevance not from any likelihood that it will uncover an error in the return, but from the mere possibility that it could. Such a standard will invite and sanction "fishing expeditions" of the sort that were denounced in *Matras*—and about which this Court expressed concern in *United States v. Bisceglia*, 420 U.S. 141, 150-151 (1975)—since virtually any corporate document carries the potential for leading to mistakes in the return and thus would be considered relevant under this standard.

Thus, it is important that the Court fashion a balanced standard that reflects not only the concern that the IRS not be unduly restricted in the pursuit of its audit function, but also the fact that the relevance requirement was intended as a meaningful restriction on the summons power. The flaw in the convenience standard is that it exalts the former consideration and gives short shrift to the latter.

In this connection, the application of a "convenience" standard flies in the face of Section 7605(b) of the Internal Revenue Code, which provides that "[n]o taxpayer shall be subjected to unneccessary examination or investigations." Implicit in that provision is the assumption that some examinations of the taxpayer and its records are unnecessary. The adoption of a relevance threshold turning only on convenience, however, would quickly undermine the objective of this provision, since virtually any examination of corporate records would become "necessary" to the administrative convenience of the IRS.

In addition, such an open-ended standard of relevance would substantially erode the important role which this Court has recognized that the federal courts must play in preventing abuses in the summons power conferred on the IRS. *United States v. Bisceglia, supra*, at 146. If, as the Court emphasized in *Bisceglia*, a summons "must be scrutinized by a court to determine whether it seeks information relevant to a legitimate investigative purpose," *id.*, the courts should not be permitted to transform such scrutiny into a sterile exercise by applying an all-encompassing standard of relevance. Indeed, it would seem particularly significant to the point at issue that the Court in *Bisceglia* explicitly singled out both *Matras, supra*, and *Theodore, supra*, as instances where "the federal courts have taken seriously their obligation to apply this standard to fit particular situations." *Id.*

Whichever view of relevance the Court ultimately embraces, the confusion and uncertainty fostered by the absence of a uniform relevance standard warrant the Court's immediate consideration of this issue. Only by resolving this issue can the Court hope to eliminate the disparate treatment of similarly situated taxpayers that has resulted from the application of varying standards of relevance. It is especially appropriate that the Court consider the question presented herein in view of the fact that it has previously decided to address the parallel question raised in *Arthur Young* with respect to tax accrual workpapers. These two issues share a common foundation and accordingly should be considered in tandem.

II. THE COURT NEEDS TO EXAMINE AND ADDRESS THE COMPETING POLICY CONSIDERATIONS ASSOCIATED WITH THE APPLICATION OF SECTION 7602.

Apart from the need to settle the conflicting approaches that have arisen in the application of the relevance requirement of Section 7602, there exists an equally compelling reason for this Court to consider the issue herein presented. Although Section 7602 grants the IRS extremely broad powers in terms of its ability to issue a summons for documents pertinent to an examination of an income tax return, the Court expressly acknowledged in *United States v. Euge*, 444 U.S. 707 (1980), that this power should be tempered, where appropriate, to accommodate competing policy considerations:

> "[T]his Court has consistently construed congressional intent to require that if the [IRS] summons authority claimed is necessary for the effective performance of congressionally imposed responsibilities to enforce the tax code, that authority should be upheld absent ex-

press statutory prohibition or *substantial countervailing policies*." (Emphasis supplied.)

444 U.S. at 711.

In the case of internal audit reports, there are substantial countervailing policies that warrant restricting the IRS summons power to those instances where the government can establish a reasonable expectation that the reports are directly relevant to the review of an income tax return.[2]

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[2] These policies have found explicit legislative recognition in Section 102 of the Foreign Corrupt Practices Act of 1977, 15 U.S.C. 78m(b)(2), wherein Congress mandated that

> "Every issuer which has a class of securities registered pursuant to section 781 of this title and every issuer which is required to file reports pursuant to section 78o(d) of this title shall—
>
> (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and
>
> (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—
>
> (i) transactions are executed in accordance with management's general or specific authorization;
>
> (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;
>
> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
>
> (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences."

In addition, the Securities and Exchange Commission (in ASR No. 123) has strongly advised, and since 1978 the New York Stock Exchange has required, that all domestic listed companies maintain audit committees of outside directors to supervise the internal audit function.

Internal audit reports are designed primarily to insure compliance with internal policies and procedures and to gauge efficiencies at various levels of operation. Such reports yield discernible benefits to the public. First, the preparation of such reports encourages and helps to assure that corporate taxpayers will comply voluntarily with the numerous statutes and regulations to which they are subject, such as those dealing with securities regulation, environmental protection, and equal employment opportunity. The societal benefits deriving from this type of self-regulation that internal audit reports promote cannot be disputed. Second, the preparation and utilization of internal audit papers help to preserve and improve managerial and operational efficiency by virtue of the information they provide. The public is the ultimate beneficiary of the by-products of such efficiency—lower prices, greater returns to investors, and higher employment, to name a few. It was plainly the recognition of such considerable societal benefits that stimulated the legislative and administrative efforts to require publicly held corporations to institute such internal procedures. However, many of these benefits will inevitably be blunted if the IRS summons power is not tempered by such countervailing considerations.

If the IRS is permitted to secure internal audit reports absent a showing of reasonable expectation that the reports will bear directly on the accuracy of the income tax return, the preparation and effectiveness of such reports will be seriously diminished. The value of internal audit reports derives in large measure from the fact that they represent an honest assessment of compliance with corporate policies and statutory and regulatory requirements. Such full and frank disclosure will no doubt dissipate once it becomes known that the Service can obtain virtual routine access to such reports without any demonstration of their pertinence

to its audit examination.[3] In short, permitting the Service to conduct its audit investigations in such an indiscriminate manner will produce a chilling effect on the willingness of company personnel to approach such reports with candor and completeness. As a consequence, the public benefits resulting from the uninhibited preparation and utilization of internal audit reports will be lost.

Ironically, this sacrifice will in the final analysis yield no offsetting benefit through improved IRS audits, since the chilling effect of such routine disclosure will effectively eliminate any substantial value that such reports might have had to the Service — even in those instances where the Service could have satisfied the "reasonable expectation" threshold. In the end, allowing IRS access to internal audit reports on a regular basis will preclude the numerous social benefits flowing from an unimpeded internal audit program with no compensating improvement in IRS audit operations. In the face of such a no-win result, it is difficult to conceive a clearer case in which countervailing considerations warrant some reasonable qualification to the IRS summons power. It is accordingly both appropriate and necessary that the Court moderate the IRS summons power to reflect the coordinate legislative recognition of the benefits stemming from an uninhibited internal audit procedure.

It is for these reasons that this Court should tailor criteria for the application of the relevance standard laid down in *Powell* which balance the government's desire for the accurate and efficient determination of corporate tax liability with the public's need that corporate taxpayers be assured of confidentiality with respect to internal audit re-

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[3] Since 1980 the IRS auditors have in fact been instructed as part of their "preliminary audit work" to review basic records of the taxpayer which "as a minimum should include," *inter alia*, internal audit reports. II Internal Revenue Manual (Audit) (CCH) Ch. 600, §622(2)(a) (1980).

ports absent a showing of immediate and identifiable relevance. The public benefits engendered by the effective use of internal audit reports justify affording such reports protection from disclosure except in extraordinary and well-defined circumstances.

CONCLUSION

There are two reasons why this Court should decide at this time the circumstances in which internal audit reports are subject to disclosure in the course of an IRS audit examination. First, there is a manifest conflict of decisional authority in this area which requires resolution. Second, there are compelling policy considerations justifying certain limitations upon the scope of the IRS's summons power which need to be addressed by this Court. Accordingly, the petition for a writ of certiorari to the United States Court of Appeals for the Sixth Circuit should be granted.

Respectfully submitted,

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Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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BRIEF *AMICUS CURIAE* OF WHITE CONSOLIDATED INDUSTRIES, INC. IN SUPPORT OF PETITIONERS

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BRIEF *AMICUS CURIAE* OF WHITE CONSOLIDATED INDUSTRIES, INC. IN SUPPORT OF PETITIONERS

This brief in support of Petitioners' petition for a writ of certiorari is submitted with the written consent of counsel to all parties, copies of which have been filed with the Clerk of the Court.

INTEREST OF THE *AMICUS CURIAE*

White Consolidated Industries, Inc. is, like Leaseway Transportation Corp., a business concern utilizing Internal Audit Reports ("IARs") for purposes of internal policing. If the government's position is sustained without some restrictions as to a determination of relevancy of IARs to the tax return, internal controls will be weakened substantially.

SUMMARY OF ARGUMENT

Managements of many business firms utilize IARs for the purpose of policing their operations to ensure compliance with applicable laws and corporate policy. Making these IARs subject to discovery by an Internal Revenue Service ("IRS") administrative summons without a particularized showing of relevance would destroy their confidentiality and usefulness and thereby erode the public interest in promoting voluntary compliance with applicable laws and regulations. For this reason, the government's position should be rejected.

ARGUMENT

White Consolidated Industries, Inc., ("White") is a Delaware Corporation engaged in the manufacture and sale of major household electrical appliances and industrial machinery and equipment. These products are manufactured in the United States and sold both domestically and abroad.

At its forty plants in twenty states, White is subject to such federal laws as the Clean Air Act, the Clean Water Act, and the Occupational Safety & Health Act as well as to various similar state laws. There are many other federal and state laws affecting not only the operation of White's manufacturing facilities but also its relations with stockholders, customers, and local governments.

This case presents an issue that transcends the mere right of the IRS to discover IARs by administrative summons. Under our form of government, individuals and businesses endeavor to know the law as it applies to a given situation and, more importantly, to comply voluntarily with it. This condition is recognized by the IRS in its Statement of Procedural Rules, 26 C.F.R. § 601.103 (a), which reads in part: "The federal tax system is basically one of self-assessment. In general each taxpayer . . . is required to file a prescribed form of return which

shows the facts upon which tax liability may be determined and assessed."

An individual in that capacity knows what he has done. However, in a corporate business such as White's, responsibility must be delegated. For example, a directive may go from the executive office to a plant office requiring the installation of equipment to eliminate certain pollution. The IARs report on the progress of the executive directive and whether the desired objectives have been met. For this and other related reasons, certain employees audit the project and make confidential reports to management for its use in measuring compliance with the law.

Thus, IARs serve to promote the public interest in ensuring the corporation's compliance with the various statutes, rules, and regulations to which it is subject. The effect of the decision of the United States Court of Appeals for the Sixth Circuit in this case would be to permit virtually routine access to IARs by the IRS. Such access would result in a serious erosion of the usefulness of IARs to corporate management in monitoring corporate adherence to pertinent laws and regulations and thus would have a negative impact on the public interest in promoting voluntary compliance.

The summons authority of the IRS to examine corporate records is set forth in Section 7602 of the Internal Revenue Code, which provides in pertinent part:

> For the purpose of ascertaining the correctness of any return, . . . the Secretary or his delegate is authorized—
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon . . . any officer or employee of [the taxpayer] . . . to appear before the Secretary or his delegate at a time and place named in the sum-

> mons and to produce such books, papers, records, or other data . . . as may be relevant or material to such inquiry.

The Code makes it plain, however, that the IRS summons power is not without limits. Thus, Section 7605(b) provides in part that "[n]o taxpayer shall be subjected to unnecessary examination or investigations."

The *amicus curiae* submits that this case requires a careful balancing of the needs and rights of the IRS to information relevant to a determination of tax liability with both (1) the needs and rights of the taxpayer to have and use confidential IARs in managing its business, and (2) the paramount public interest in promoting voluntary corporate compliance with state and federal laws and regulations applicable to American businesses. It is essential to the continuation of our self-assessment tax system and to voluntary compliance with the laws of the land that IARs not be subject to routine disclosure to the IRS pursuant to the summons power but rather that they be made available only upon a particularized showing of relevance by the IRS.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari to the United States Court of Appeals for the Sixth Circuit should be granted.

Respectfully submitted,

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